Regulation

Fall 1990 The Cato Review of Business & Government

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Assessing Private Antitrust Enforcement

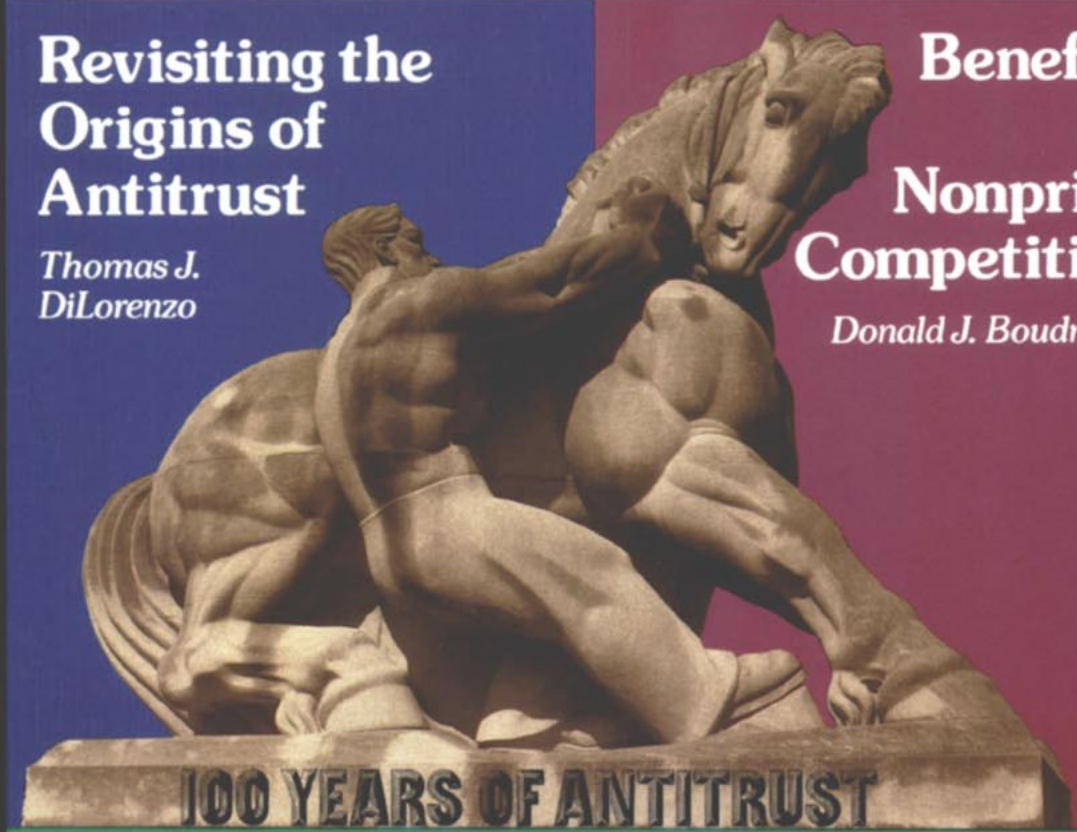
William F. Shughart II

Revisiting the Origins of Antitrust

Thomas J. DiLorenzo

Benefits of Nonprice Competition

Donald J. Boudreaux



Competing for Onshore Oil Leases

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Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Choices in Medical Insurance

TO THE EDITOR:

Simon Rottenberg's article on medical insurance ("Unintended Consequences: The Probable Effects of Mandated Medical Insurance," *Regulation*, Vol. 13, No. 2, 1990) correctly points out that four out of five of the uninsured have a direct link to someone in the labor force. This suggests that the source of the problem lies in the medical care marketplace itself. Full-time workers and their families should be able to afford basic, no-frills medical insurance policies with coverage for catastrophic and major medical expenses. Unfortunately, it appears that these workers have been priced out of the market for medical insurance by federal and state policies that provide tax incentives for some, but not all, workers and that require workers to pay for coverage that they may not want or need. Both of these problems must be addressed to remedy the current situation.

Many experts attribute the difficulty that small business employees encounter in obtaining medical insurance to the proliferation of state mandates on consumers. While Professor Rottenberg mentions the role state insurance mandates play in this area, he does not make his case forcefully enough.

Mandates are nothing more than concessions to special interests looking to coerce millions of consumers into purchasing coverage for specific diseases or health services, whether they want that coverage or not. John Goodman of the National Center for Policy Analysis in Dallas (NCPA), who has done more than anyone else to alert Congress to the negative effects of mandates, found that the total number of mandates exploded from 30 in 1970 to about 700 in 1988. In 1989 this trend continued, as state legislatures added an additional 60 mandates.

What has been the result of all these mandates? Unfortunately, millions of hard-working Americans have discovered that the cost of even the most basic medical insurance policy is beyond their reach. The NCPA estimates that 32 percent of the 5 million Californians who were without medical insurance in 1986 were priced out of the marketplace by state mandates. In some states as many as 60 percent of the uninsured are the victims of mandates. Nationwide, up to one quarter of the uninsured—9.3 million in all—would be able to afford basic, no-frills medical insurance if some or all of these mandates were repealed.

The states have begun to realize the enormous cost of this approach. For example, several states now require the proponents of new mandates to demonstrate that the benefits exceed the costs. That burden has proven to be so overwhelming that the state of Washington has rejected every single proposed mandate since the law went into effect in 1983. Hawaii requires a social and financial impact statement before the passage of new mandates.

Measures pending in Rhode Island and Virginia go even further. The Rhode Island proposal, recently approved by the state legislature, would establish a 30-month experimental program that would allow insurers to sell no-frills health insurance plans that are exempt from state insurance mandates. These plans would include coverage for 20 days of inpatient and outpatient care, including surgery and anesthesia, preadmission testing, radiation therapy, and chemotherapy. The sponsor of the plan, Sen. James Donelan, estimates that it would reduce medical insurance premiums by 50 percent.

In Virginia a proposal would allow insurers to market mandate-exempt policies to businesses with fewer than 50 employees. This has prompted Blue Cross & Blue Shield of Virginia to offer a no-frills policy for an adult with one child that would cover 30 days of hospitalization and preventive care at an annual cost of $1,644, about *half* the $3,168 it now costs to purchase a standard major medical policy in Virginia.

By driving up the minimum cost of medical insurance policies, these mandates have forced millions of insurable Americans out of the marketplace entirely. Professor Rottenberg is entirely correct. It is the obligation of government to offer consumers a choice in the purchase of health insurance; no person should be forced to pay for coverage that he does not want.

In addition, Professor Rottenberg's analysis would be strengthened by a brief discussion of how the federal tax code contributes to the problem of the uninsured. Under current law, a large employer can bypass all state mandates simply by self-insuring under the Employee Retirement Income Security Act, which entitles employees to receive an unlimited package of health benefits on a tax-free basis. Estimates of the average annual value of this benefit vary, but appear to be close to $2,750 per employee. As one might expect, the cost of these plans has skyrocketed; Foster Higgins estimates that the average cost of employer medical plans increased 20.4 percent in 1989 alone. In some industries the average cost per employee now exceeds $3,300 per year.

As we all know, many companies provide their employees with complete, first dollar coverage for a wide array of benefits; in fact, last year the single greatest obstacle to a settlement in the strikes against the regional Bell operating companies was the nature and extent of the employees' medical benefits package. In one instance union negotiators accepted a cut of $125 million in wages and other benefits in exchange for continued first dollar medical insurance coverage.

Sophisticated union negotiators

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would not sacrifice substantial salary gains if there were some sort of ceiling on the tax exclusion for employer-provided benefits. As Professor Rottenberg points out, the availability of unlimited health coverage has seduced most employees in self-insured firms to shift compensation away from salary and to accept enhanced medical benefits packages in its stead. In fact, employer contributions for group medical insurance increased from only .8 percent of the employee's compensation in 1955 to 5.1 percent in 1987. According to the House Ways and Means Committee, the value of the tax exemption for employer-provided coverage will exceed $50 billion by 1994.

Thus, employees in large, self-insured firms receive generous tax subsidies for unlimited, gold-plated coverage, while their counterparts in small firms enjoy no comparable incentives and must purchase coverage with after-tax dollars.

Last year, the Congressional Budget Office (CBO) estimated the revenue effects of a rather generous ceiling of $3,000 per employee per year for family coverage and $1,200 per employee per year for individual coverage. It found that this change would increase federal revenues by $60.5 billion over five years, and by more than $20 billion in 1994 alone. CBO speculated that such a reform would discourage workers from demanding additional coverage beyond the ceiling. "Without such coverage," CBO included, "there would be stronger incentives to economize in the medical marketplace, thereby reducing upward pressure on medical care prices."

In my view, it is the obligation of the federal government to guarantee that all full-time workers, even those with earnings at or slightly above the minimum wage, can afford basic insurance coverage for themselves and their families. If governmental intrusions into the marketplace raise the cost of medical care and insurance to an unacceptable and unaffordable level, as I believe they have, it is the obligation of Congress to eliminate these distortions and to restore the integrity of the free market.

A comprehensive solution should guarantee that the tax code provides adequate incentives to working persons who want to purchase medical insurance and do not receive this benefit from their employers. It should also encourage relatives to help less fortunate family members to purchase insurance.

These tax incentives should not be unlimited. Thus, the tax code should provide generous incentives for the purchase of no-frills, major medical coverage, but the incentive should stop there. The unlimited nature of the tax exemption for employer-provided medical benefits encourages employees to use medical services that they may not need and regardless of their cost. This, in turn, fuels the inflationary spiral of medical care, which has increased at twice the rate of inflation for most of the past three decades. Our tax code should not further encourage this trend.

To make such a ceiling attractive to taxpayers, employers would be required to offer employees the option of receiving the taxable portion of their package as additional salary in exchange for reduced coverage.

Employees who work for small firms and the self-employed comprise a disproportionately large share of the uninsured population. The tax code should provide them with an incentive to purchase medical coverage that approximates the incentive available to those who work for the larger, self-insured employers. The ability to obtain affordable medical insurance, in other words, should not be a function of an individual's employment setting. Thus, a comprehensive, market-based initiative to expand the availability of medical insurance must also include a tax credit for the purchase of no-frills policies with coverage for major medical emergencies and high deductibles.

In addition, it is essential that our tax code provide strong incentives for taxpayers to self-insure for small, out-of-pocket expenses through a device similar to an Individual Retirement Account. Such an account would permit taxpayers to receive a tax credit for contributions to a savings account with interest accruing on a tax-free basis, provided that withdrawals are used for eligible medical expenses. This credit would be available to *all* taxpayers, even those who receive their medical coverage through their employers.

Medical IRAs are important because they enable consumers to purchase policies with higher deductibles, and thus lower their premiums and enhance their ability to control health expenditures. The proliferation of low deductible policies—and Messrs. Kennedy and Waxman's attempt to codify their existence in the Basic Health Benefits for All Americans Act—shifts the responsibility for predictable and recurring expenditures to third-party insurers. In many high-cost areas, asking insurers or employers to provide policies with low deductibles is asking them to insure noninsurable events. The more that consumers police their own medical care expenditures, the more likely it is that we can restrain the annual double-digit increases in the cost of hospital and physician care.

My proposed solution contains the following provisions:

- Create a federal option to state insurance mandates with respect to (1) diseases and disabilities, (2) medical services, (3) types of health care providers and provider organizations, and (4) maximum or minimum levels of deductibles, coinsurance payments, or payment rates. State insurance mandates have priced too many workers out of the medical insurance marketplace. Consumers should not have to pay for coverage they do not want.

- Establish a tax credit for the purchase of no-frills medical insurance policies. The credit would be refundable to low-income taxpayers and would be set according to the age of the taxpayer. Its size would approximate the cost of a no-frills medical insurance policy with a high deductible in a medium-cost state. For individuals who want to assist less fortunate relatives, the dependent support test would be waived.

- Create medical care savings accounts. To encourage taxpayers to self-insure for small, out-of-pocket medical expenses, my bill will offer taxpayers a second tax credit for contributions to an account similar in concept to an Individual Retirement Account. Interest would accumulate on a tax-free basis so long as the taxpayer uses the proceeds for eligible medical expenses. Only taxpayers who have purchased medical insurance would be eligible to take advantage of this device.

- Enable employees who receive health benefits from their employers to trade any unwanted benefits

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for additional salary. By placing a ceiling on the tax subsidy for employer-provided health benefits, my bill will enable employees who receive unwanted coverage to accept a scaled-back package of benefits in exchange for additional salary. The federal government should not underwrite the cost of unnecessary or frivolous insurance coverage.

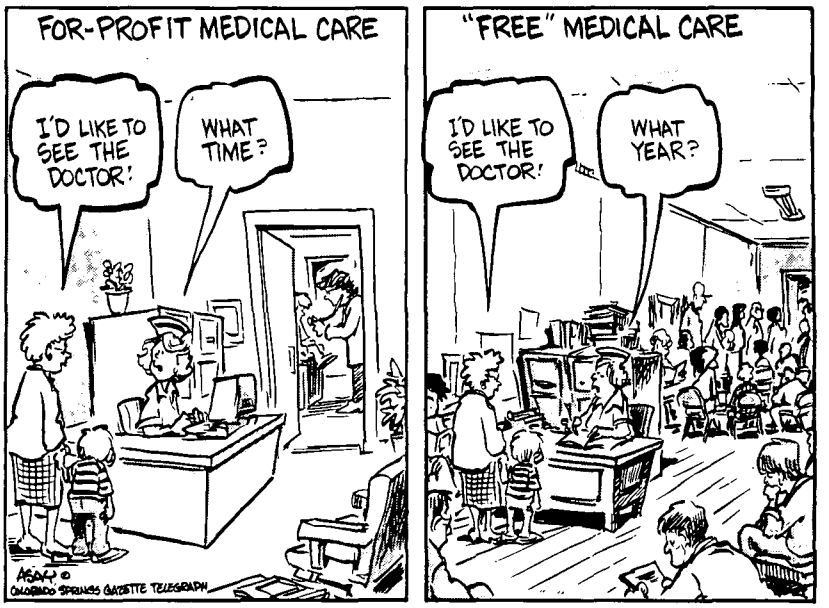
● Enable prospective patients to learn the estimated cost of any nonemergency hospital services before receiving them. Upon request, hospitals would have to provide patients with a good-faith estimate of the charges likely to be assessed for hospital, physician, and other forseeable services. Patients would also be told the success rates for contemplated procedures as well as the availability of nonsurgical alternative treatments. In advance of a hospital stay, patients should be entitled to learn that hospital *A* charges $6,000 for a hernia operation, hospital *B* charges $4,500, and hospital *C* charges only $2,500. Greater consumer knowledge of medical care costs should benefit consumers and limit the steady double-digit increases in the cost of health care.

To provide low-income families with the same tax benefits as more affluent families, both tax credits mentioned above would be "refundable." This means that a family with a tax liability that is less than the value of the credit would receive money back from the IRS.

The above proposal should be revenue neutral: it should neither increase nor decrease federal tax revenues. We must recognize that, from a federal budgetary perspective, we are living in lean times. Reducing the deficit must be a paramount concern in our attempts to provide insurance to the 37 million Americans who lack it.

The "Choices in Medical Insurance" approach outlined above would recognize the central role that the free market plays in creating wealth and allocating resources among competing needs. The federal government should adopt an internally consistent policy that encourages individuals to purchase medical insurance, but at the same time rewards them for making prudent decisions with their medical care dollars. I believe that my approach represents a positive step in that direction.

William E. Dannemeyer
Member of Congress
Washington, D.C.



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Soaking the Poor

TO THE EDITOR:

The unintended consequences of mandated medical insurance that Simon Rottenberg outlined ("Unintended Consequences: The Probable Effects of Mandated Medical Insurance, *Regulation*, Vol. 13, No. 2, 1990) are the inevitable result of the faulty assumptions on which the Kennedy-Waxman approach is based. Proponents of mandates assume that employers are wealthy, employees are poor, and the only reason wealthy employers do not provide health insurance to poor employees is greed.

A more appropriate analytic model, though still overly simplistic, finds relatively wealthy and relatively poor employers as well as relatively wealthy and relatively poor employees. The problem for Kennedy-Waxman is that relatively wealthy employers tend to be matched with relatively wealthy employees and vice versa. Those matches imply that employees of relatively successful businesses will have health insurance benefits and employees of relatively unsuccessful (or not yet successful) businesses will not. For example, data collected earlier this year by the NFIB Foundation discovered—surprise! surprise!—that business income was directly related to sponsorship of employee health insurance. Just over 20 percent of small employers earning less than $10,000 from their businesses—$10,000, that is not a misprint—sponsored an employee health plan. The percent sponsoring a plan rose like stair steps with each $10,000 increment of business income. At the top, about 95 percent of those small employers who took $70,000 or more from their businesses in 1989 sponsored an employee plan.

The Kennedy-Waxman proposal attempts to transfer wealth from relatively poor employers to relatively poor employees. If a relatively poor employer cannot cough up this regressive tax—and a tax it surely is—then relatively poor employees have the privilege of paying it in the form of lost jobs, fewer hours, etc. This "soak-the-poor" philosophy seems at odds with Kennedy-Waxman rhetoric, but then it is the direct result of analytic assumptions that should have died long ago.

William J. Dennis, Jr.
Senior Research Fellow
The NFIB Foundation
Washington, D.C.

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A National Dilemma

TO THE EDITOR:

This is in response to Professor Simon Rottenberg's article "Unintended Consequences: The Probable Effects of Mandated Medical Insurance," *Regulation*, Vol. 13, No. 2, 1990). Professor Rottenberg's article showed tremendous insight and expertise on the issue of mandated benefits.

The issue of health care reform is often clouded by the questions: Do we have a right to medical insurance? Or is medical insurance a privilege? And whose responsibility is it to provide medical insurance? Regardless of the answer, what is important is that all Americans have access to health care.

Access to health care, however, must be available in a free market system with minimal government intervention. The professional agent and the insuring industry play a vital role in educating the consuming public and in the delivery of products and services.

We must take care to avoid a system of rank and privilege such as Great Britain has created, where only the wealthy can afford private hospitals and where personal doctors are on retainer. Also, a system of rationed care, as practiced in Canada, can give certain members of society priorities on high technology medical procedures.

If a person must wait months or years to become eligible for surgery or treatment that could save his life now, how does this differ from being uninsured? If benefits are not available when needed, then why have coverage at all, especially coverage for which significant personal taxes have been levied.

The National Association of Health Underwriters believes that individuals and not the government should make the choices and take responsibility for health care. We support a combination private/public solution with appropriate accountability and free market diversity. Only a solution based on proper private-sector incentives will ultimately achieve a viable and affordable long-term solution to this national dilemma.

Vince Lombardo
Communication Chair
National Association of Health Underwriters Legislative Council
Washington, D.C.

A Regressive Tax

TO THE EDITOR:

Simon Rottenberg's article on mandated medical insurance "Unintended Consequences: The Probable Effects of Mandated Medical Insurance," *Regulation*, Vol. 13, No. 2, 1990) was very well done.

What is generally not recognized is that mandated medical insurance is a regressive tax on the employee's wages.

Social Security, worker's compensation, and unemployment compensation all represent a uniform percentage tax upon employment. But the cost of mandated medical insurance, as a percentage of salary, increases as the value of the worker decreases.

In 1989 the average cost of group medical insurance in America was $2,748 per employee. If the employer had paid 80 percent as Kennedy-Waxman would require, that cost to the employer would have been $2,200 per employee—7 percent of compensation for an employee earning $30,000 but 21 percent of annual compensation for an employee earning $5 per hour, and 31 percent of the 1989 minimum wage.

At the current rate of cost increase for medical insurance, the average cost of group coverage in 1990 will be more than $3,100 per employee. The 80 percent required by Kennedy-Waxman will be $2,500, more than $200 per month per employee.

If employers are at all rational in how they spend their money, mandated medical insurance makes it even more irrational to carry the marginal employee on the payroll. The small employer is especially responsive to these kinds of disincentives. "Mom and Pop" simply resolve to sweep the place out themselves, instead of paying that high school dropout.

Instead of calling the Kennedy-Waxman measure the Minimum Health Benefits for All Workers Act, it can be retitled the "Increase Unskilled Workers' Unemployment Act" or the "Increase Crime in the Inner Cities Act," for the idle unemployed generate a major share of our nation's crime.

In the case of the minimum wage, inflation has acted to minimize the damaging effect, for each year inflation reduces the real minimum wage. There is nothing to similarly ameliorate the damaging impact of a regressive payroll tax for medical benefits.

In fact, the opposite is true, for the cost of medical insurance has been increasing on the average of four times the rate of the CPI. In 1989 the average medical insurance cost increased 20.4 percent with the CPI at 4.8 percent.

Nor will its effect in increasing unemployment be a passing phenomenon. Because the regressive tax is a continuing disincentive to the employment of marginal workers, its effect will continue and will get worse as the cost of medical insurance continues to climb at four times the CPI.

It is likely that political realities will intervene to exempt the smallest firms from the mandated benefits requirement, which is what occurred in Massachusetts when the Dukakis administration got mandated medical insurance passed in 1988—passed but never put into effect.

The Massachusetts bill exempted employers with fewer than six workers. That means that the real cost to hire the sixth worker is not wages, nor wages plus health benefits, but wages plus medical benefits for six. At $2,500 each, that is $15,000 in medical benefit cost connected with hiring the sixth worker.

America does have a program for the uninsured. The program is simply not what a lot of people prefer. The program that exists is a variety of government welfare programs to assist the uninsured, and it is cost shifting.

Hospitals do not like cost shifting. Yet, the fact is that hospitals have never been so prosperous as they are today.

Cost shifting is a minor unpleasantness. But it is not a disaster, and it has not brought America's engine of growth to a halt. Cost shifting has not caused small businesses to stop their growth rather than to hire that sixth worker, and it has not increased the unemployment rate.

The Kennedy-Waxman bill to "Increase Unemployment" is the best we could concoct to do damage to the nation's growth engine and to increase unemployment among the least skilled.

J. Patrick Rooney
Chairman of the Board
Golden Rule Insurance Company
Indianapolis, Ind.

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Regulatory Snipping

TO THE EDITOR:

Kathleen Utgoff is to be applauded for drawing attention to the untenable situation in which pension plan sponsors have been placed ("The Proliferation of Pension Regulations," *Regulation,* Vol. 13, No. 2, 1990). Companies still want to offer pension plans, but, as Ms. Utgoff points out, more and more frequently they are forced to conclude that the price they must pay is excessive. This is particularly true of smaller firms. A business owner who sees that he must pay to actuaries, attorneys, and consultants the dollars that he would like to set aside for his employees is inclined to wonder why Congress is working so hard to discourage plan formation.

With rules changing—always in the direction of complexity—every year, neither businesses nor workers can plan intelligently for the future. The quest to generate tax revenue and the use of pension law as an income redistribution tool have obscured what ought to be a basic social policy goal: ensuring that American workers and their families can face retirement without a precipitous drop in their standard of living.

The U.S. Chamber of Commerce seconds Ms. Utgoff's call to "stop pruning the trees and look at the forest." An aging population needs greater retirement income security, not less, and business needs incentives to provide a significant portion of that security. Legislative and regulatory snipping, complicating, and micro-managing are clearly not the answer.

Lisa M. Sprague
Manager-Employee Benefits Policy
U.S. Chamber of Commerce
Washington, D.C.

A More Subtle Understanding?

TO THE EDITOR:

Insurance industry consultant Benjamin Zycher's analysis of the liability insurance crisis and Proposition 103—the landmark insurance reform initiative passed by California voters in November 1988—("Automobile Insurance Regulation, Direct Democracy, and the Interests of Consumers," *Regulation,* Vol. 13, No. 2, 1990) is a confused collection of ideological contradictions, dubious statistics, misrepresentations, and falsehoods that ill serves the readers of *Regulation.* Indeed, the liability insurance issue is one that mandates a more subtle understanding of the industry, as a few reflections on Zycher's article reveal.

Zycher prefaces his critique of insurance regulation by noting increases in medical care and litigation costs that, he suggests, account for the skyrocketing rate increases that energized Proposition 103's passage. But in his blizzard of statistics, Zycher leaves out the most relevant one: increases in auto, homeowner, and business insurance rates outdistanced the CPI increases in component costs by more than 20 percent between 1985 and 1987.

What explains the difference? Even industry experts now admit that insurance rates were inflated during those years to offset lower profits caused by poor investment decisions and a falling interest rate in the early 1980s—economic realities that have nothing to do with insurance claims.

Relying on an erroneous and discredited study trumpeted by the insurance industry during its $80 million campaign against Proposition 103, Zycher also criticizes the elimination of the territorial rating system, under which insurers base premiums on a motorist's zip code.

Rather than delegate underwriting decisions to the Postal Service, Proposition 103 requires insurers to base premiums primarily upon a motorist's safety record and driving habits—factors that, contrary to Zycher's statement, are a better predictor of risk of loss than one's zip code. This provision of Proposition 103 corrects a long-standing practice rooted in overt discrimination against members of certain religions, women, minorities, the poor, and immigrants—often categorized as "unacceptable risks" by insurers and denied insurance, even though they would qualify as good drivers.

Perhaps most surprising, Zycher defends industry practices that would revolt any true advocate of free-market economics.

In repealing the insurance industry's exemption from the antitrust laws, Proposition 103 outlawed the standard industry practice of circulating price, expense, and anticipated loss data among insurers (consumers were never permitted to obtain the information), which inevitably led to the kind of anticompetitive practices that the antitrust laws are designed to prohibit.

Zycher feebly attempts to justify the antitrust exemption for insurers by claiming that it helped small insurers to compete. (In fact, Proposition 103 specifically permits insurers to share *historical* loss data, which is what the minor insurers most need). But why do certain members of one industry deserve exemption from the antimonopoly laws applicable to every other commercial enterprise in the nation?

Finally, Zycher fabricates a quotation from me to suggest that Proposition 103's 20 percent rollback was arbitrary and hence unjustified. In fact, the California insurance commissioner—an opponent of Proposition 103—has already called for over $1 billion in rollbacks, based on hearings that detailed the industry's enormous waste, inefficiency, inflated reserves, and surplus, and artificial accounting practices—the product of years of insulation from either competition or regulation. A study recently released by the California attorney general concludes that a 20 percent rate rollback—or more—is justified for most California auto insurers.

Zycher's readers may share his antipathy to government regulation. But why should motorists in California and elsewhere be *forced* to buy a product—an auto insurance policy, on pain of fines and a jail term—that is deliberately overpriced to offset investment losses for which the consumer is not responsible?

Zycher suggests that the voters do not have the right to insist on standards of fairness, full disclosure, and greater accountability from those corporations granted the privilege of selling us insurance. The only folks I know who agree with Zycher on this point are the insurance companies that employ him.

Harvey Rosenfield
Chairman
Voter Revolt
Los Angeles, Calif.

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THIS COVER STORY ON CALIFORNIA IS DEVASTATING.
NEWSWEEK
THIS SORT OF CRITIQUE COULD SERIOUSLY TARNISH OUR STATE'S IMAGE.
TOURISM WILL DROP...PEOPLE WON'T WANT TO MOVE HERE.
HEY, EVERY LITTLE BIT HELPS...

Drawing by Skelley; Copley News Service.

Setting the Record Straight

ZYCHER responds:

I am shocked. The editors of *Regulation*, upon the editorial advisory board of which I am privileged to sit, have allowed some imposter to sign the above letter with the name of Harvey Rosenfield, chairman of California's own Voter Revolt, champion of hapless consumers, and Johnny Appleseed of money trees for all. The real Harvey Rosenfield, the one that we have come to know and love, would never allow his name to grace arguments so old, so tired, so worn out, and so devoid of analytic content. The real Harvey Rosenfield—leftist, corporation basher, Ralph Nader-in-Training—would have had a much better go at my article.

Well, wait a minute. There *is* the possibility that Harvey is just a bit past his prime, like the old prizefighter who cannot hear the bell or see his opponent, but who still straps on the old gloves for a little shadow boxing before some coyotes howling at the full moon. And—let's face it—Harvey's self-confidence probably was not enhanced by the recent trouncing given his anointed candidate for insurance commissioner, the ineffable Conway Collis. The voters can be so fickle. And come to think of it, the letter *does* contain some telltale signs—some fingerprints, if you will—of the real Harvey Rosenfield. To wit:

● *Innuendo.* For reasons both crude and subtle, Rosenfield seems incapable of writing my name without the preceding phrase "insurance industry consultant." As an aside, that characterization is laughable, since my "consulting" for the insurance industry comprises all of two items: a detailed rebuttal of a sophomoric attorney general "study" submitted to the insurance commissioner, and editing of a paper presented at an industry conference. In any event, this attempt by Rosenfield to avoid the analytic issues is an example of a time-honored tactic used by the Nader crowd to cut off debate before it begins. They love to insinuate that anyone in disagreement with their viewpoint has a crass vested interest. What Rosenfield will never publicize is his own use of real, full-time, insurance industry consultants who, for whatever reasons, are willing to sign off on positions adopted by Rosenfield. And, oops, did Harvey forget to mention the depths to which he and his mentor, the great Ralph Nader, have their snouts imbedded in the trial lawyers' trough? For details, dear readers, take a look at the September 17 issue of *Forbes* and the September issue of *The American Spectator*. Suffice it to say that when it comes to dishonesty in defense of a vested interest, Rosenfield and Nader take a back seat to no one. Nonetheless, you will search my article in vain for references to such matters, for they have nothing to do with the substance of the issues. Rosenfield has not a clue as to how to do rigorous, substantive analysis, and so he retreats to such irrelevance.

● *Ignorance.* Rosenfield consistently displays the mind-set of an old-fashioned bureaucrat attempting to implement price controls and wondering why they never work. After all, should prices of goods not be determined by the accounting prices of component inputs? Well, no, Harvey, for all kinds of reasons, but let us focus here on your silly comparison of insurance rates and the CPI for component costs. Such sector-specific CPI data abstract from changes in the mix of inputs—medical care, property repair, litigation, etc.—that together make up the changing basket of insurance services over time. Suppose, for example, that an "average" claim comprises one $1,000 medical cost and one $500 repair cost. Thus, an average claim is expected to cost $1,500. Let there be no changes whatever in the CPI for either medical care or auto repair; but suppose the average claim now shifts to, say, 1.5 medical costs and .5 repair costs. Guess what, Harvey: the average claim now costs $1,750 despite the fact that the CPI has not changed at all. I admit that I had to explain this to my daughter twice before she understood it. Of course, she is only ten years old.

Moreover, if the medical care CPI is rising faster than the auto repair CPI, a spending shift toward medical care can raise insurance costs faster than the average rise in the component CPIs. In simple terms, Rosenfield just does not understand the difference between a weighted and an unweighted average; that the California insurance market must undergo its current agony because of his ignorance is appalling. And Rosenfield's obsession with component CPI changes abstracts from the implicit California Automobile Assigned Risk Plan subsidy so beloved by him and his "consumerist" allies; precisely where, sir, does that show up in the CPI data? Moreover, insurance rates must be determined by expected costs rather than by historical costs reported by the CPI. It would be easy to go on, but you get

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the idea: Rosenfield has not an inkling with respect to his ignorance of price determination in markets.

● *Stupidity.* Apparently, Rosenfield really believes that investment losses are the source of rising insurance rates. But if a firm could make more money by raising its rates, why wait? Why not raise them regardless of investment performance? The flip side of Rosenfield's argument is equally silly: if an insurer finds a pot of gold (i.e., its investments do well), it will lower its rates. In truth, market forces will force prices down by the *expected*—not actual—returns to investments made with policyholders' premiums. If a company earned an unusually large amount on investments, it would have no incentive simply to give the wealth to policyholders rather than to shareholders. It would be equivalent to a discovery by the company president of a cache of gold in the basement. Similarly, investment losses are analogous to those due to a burglary of company offices: they affect neither the demand for nor the marginal cost of insurance. If a company tried to recoup investment losses by raising premiums, consumers would flee to competitors.

The upshot of this comic-book view of market behavior is infinite heterogeneity in prices for identical insurance services, that is, after controlling for often subtle differences in the quality of the product. Can anyone possibly believe in the viability of such a pricing outcome? Unsurprisingly, Rosenfield does, just as he seems to believe that a given driver represents an identical risk regardless of whether he lives in central Los Angeles or some rural county. As far as the purported "discrimination" against Rosenfield's constituencies is concerned, why was there not massive entry by greedy insurers anxious to offset their investment losses by selling expensive insurance to "good drivers" denied coverage by others?

● *Dishonesty.* Rosenfield's predictable response to that question is "collusion." After all this time—and despite the decades-old proscription on collusion in the California Insurance Code—Rosenfield still wants to argue that the antitrust "exemption" removed by Proposition 103 allowed insurers to collude. I will not repeat here the discussion in my article about why that is not true. The more relevant point is the impossibility of a successful collusive agreement among hundreds of firms, with thousands of additional potential entrants. And Rosenfield seems to believe that endless repetition of assertions about waste, inefficiency, and "artificial" accounting is a substitute for evidence. And by "evidence" I do not mean Rosenfield's infantile comparisons between insurance companies and public utilities. Give us some real evidence, Harvey. If the industry is so inefficient, why is takeover activity not rampant? And if the industry is both inefficient and "obscenely" profitable, why has there not been massive entry?

When it comes to Rosenfield and dishonesty, well, *abbondanza!* Such is the only possible response to his insinuation that the insurers were the proponents of the disastrous mandatory insurance law. The plain truth is that the insurance companies opposed the law passed in 1987 just as they had opposed similar proposals for years beforehand. The truth is that the law was pushed and ultimately passed on the efforts of Senator Alan Robbins, a strong and vocal *supporter* of Proposition 103. This dishonesty is reflected as well by Rosenfield's attempt to characterize his statement to Assemblywoman Cathie Wright—that the 20 percent figure for the rollbacks was included in Proposition 103 because "it sounded good"—as a fabrication. Well, Rosenfield can deny that statement all he wants, but the assemblywoman told me personally that he said it to her directly in response to a question about the origin of the 20 percent figure. We can believe either Rosenfield or her; forgive me, but I'll go with the lady.

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Currents

Déjà Vu

Oh my, here we go again. My latent optimism that people learn from prior mistakes has again been shaken by the domestic reaction to the recent increase in oil prices.

Politicians and the media were quick to charge the oil companies with "price gouging," even though the average price of gasoline did not increase as much as the spot price of oil. Several states are considering gasoline and oil price controls, which would cause selective shortages and pressure for national controls. Assistant Attorney General (for Antitrust) James Rill summoned oil executives to Washington to determine whether there was some conspiracy to raise domestic prices. Former President Jimmy Carter and Sen. Lloyd Bentsen, for different reasons, have revived proposals for mandated energy conservation, an oil import tariff, and targeted subsidies for energy development and alternative fuels. Congress nearly approved a large increase in the mandated corporate average fuel economy (CAFE) of new cars and light trucks, although this measure would seriously harm the domestic automobile producers without reducing the short-run demand for gasoline. (See the following Current by Robert Crandall.) The Department of Energy initially refused to release any oil from the Strategic Petroleum Reserve, without acknowledging that it has yet to formulate and announce a release policy. And even President Bush, a former oil entrepreneur, made some mushy Carteresque noises, counseling restraint by the oil companies and conservation by consumers. All of this energy policy rhetoric had the effect of a time warp; I fully expected some 1970s sitcom to follow all this news.

Our political community seems to have learned nothing about energy policy in the meantime. The apparent rationale for reviving these proposals is that an increase in the explicit or implicit price of energy caused by the government is desirable, but an increase in the price by the oil companies (to reflect the current replacement cost of oil) is undesirable. Each of these proposals would compound the problems of the recent Iraqi-provoked crisis. Let me count the ways:

- The August spike in oil prices was the result of the U.S.-imposed embargo on oil exports from Iraq and Kuwait. The Iraqi invasion of Kuwait, however deplorable, did not reduce the world supply of oil.

- Price controls on gasoline would increase the sum of cash payments, queuing in gas lines, and driving to find an open station.

- An oil import tariff would cost American consumers and industry about two and one-half times the tariff revenue, would seriously damage the petrochemical industry, and would accelerate the depletion of domestic oil reserves.

- Targeted subsidies for energy development and alternative fuels, by prior experience, would probably cost taxpayers at least twice the value of the energy produced.

- Mandated energy conservation measures, such as CAFE, would cost consumers of new products more than the value of energy saved and would reduce the replacement of older, less energy-efficient products.

- Adding more oil to the Strategic Petroleum Reserve would be a waste until both consumers and producers are confident about the conditions under which this oil would be released.

And so on. This list would have been longer if Congress and the state legislatures had not been on their summer recess.

What explains the revived demand for a pervasive energy policy? A part of the explanation is the politicans' compulsion to be perceived to be doing something in response to every crisis. As individuals, they can do nothing about Saddam Hussein, so they pillory the domestic oil com-

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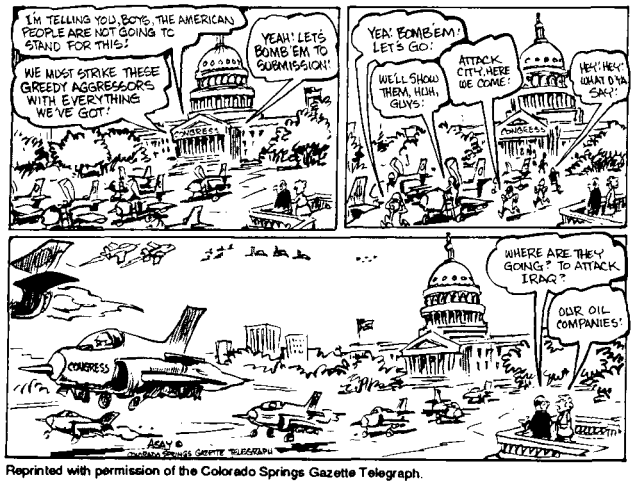
I'M TELLING YOU, BOYS, THE AMERICAN PEOPLE ARE NOT GOING TO STAND FOR THIS!
WE MUST STRIKE THESE GREEDY AGGRESSORS WITH EVERYTHING WE'VE GOT!
YEAH! LET'S BOMB 'EM TO SUBMISSION!
CONGRESS
YEA! BOMB 'EM! LET'S GO!
WE'LL SHOW THEM, HOH, GUYS!
ATTACK CITY, HERE WE COME!
CONGRESS
HEY! HEY! WHAT D'YA SAY?
WHERE ARE THEY GOING? TO ATTACK IRAQ?
OUR OIL COMPANIES!
CONGRESS
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pany executives. A more enduring explanation is an unholy alliance of puritans and the greedy, rather like the alliance of Baptists and bootleggers that supported prohibition. The puritans maintain that it is morally wrong for Americans to consume so much energy. The greedy are those who promote government favors to serve the owners of domestic energy resources and the army of underemployed energy consultants. And both groups seem ready to use any currently fashionable rationale to serve their interests. Alas!

W.N.

The Changing Rationale for Motor Vehicle Fuel-Economy Regulation

Fifteen years ago, Congress enacted the corporate average fuel-economy (CAFE) program that required each producer of automobiles for sale in the United States to achieve by 1985 a sales-weighted average of at least 27.5 miles per gallon (MPG) for new cars sold. Furthermore, each automobile manufacturer had to achieve this average for its domestic cars and for its imported cars separately; imports could not be used to offset less fuel-efficient domestically produced vehicles.

The CAFE policy was enacted in the aftermath of the Arab oil embargo. At the time, world oil prices were peaking, but U.S. prices were being held artificially low by government regulation. Fuel economy regulation was thus "necessary" because another set of government regulations kept market forces from operating. This was also the period during which U.S. crude oil prices were being kept artificially low so that the rents from U.S. production could be transferred to the Arab oil producers through an "entitlements" policy.

The presumed rationale for CAFE after the first OPEC oil shock subsided was that the United States needed protection against future oil shocks, although this case has never been explained very well. Is the United States less vulnerable to, say, a 20 percent reduction in oil supply if it is consuming only 16 million barrels instead of 20 million barrels each day? Is the required adjustment or the national-security threat any less severe?

Whatever the original case for CAFE, it has now changed considerably. The Arab OPEC states are in disarray. In the past few months real oil prices have been gyrating between $8 and $15 per barrel in 1974 dollars—a far cry from the $50 to $100 per barrel predictions that were common in the 1970s. True, imports are rising once again—oil exploration and production is not very attractive in the United States at recent prices, and U.S. environmental policy is not conducive to developing new offshore reserves—but few in Washington today are pressing for tight fuel economy standards simply to protect us from an OPEC conspiracy to drive up the price of oil.

This is the year of the environment, and the case for CAFE is now an environmental one. Recent concerns about the accumulation of carbon dioxide, CFCs, and other greenhouse gases in the world's atmosphere have created an entirely new reason to mandate strict new-car fuel economy standards. Global warming is the new concern; CAFE is still the instrument. Unfortunately, it is a very blunt instrument, likely to cause more harm than good.

The consumption of motor fuel depends on the types of vehicles driven, the price of motor fuel, and the level of overall economic activity. In the absence of fuel efficiency regulation, the fuel efficiency of *new* passenger cars sold will depend in large part on the current price of gasoline and the manufacturers' expectations of that price in the prior several years. Between 1979 and 1981, CAFE was largely irrelevant as automobile companies scurried to introduce new fuel efficient cars in the aftermath of the Iranian Revolution. As real motor fuel prices plunged after 1981, fall-

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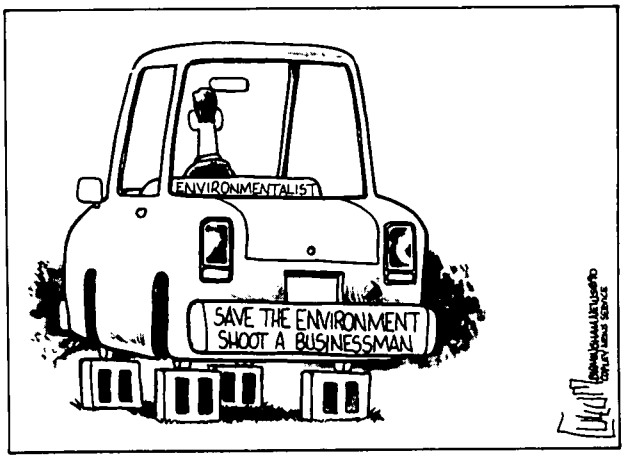
ing by 1986 to their lowest levels since World War II, Americans understandably began to demand larger and more powerful cars once again.

In 1985 Ford and General Motors found themselves in a very difficult position with gasoline prices falling to these very low levels, but CAFE pegged at 27.5 MPG. They raised large-car and large-engine prices to avoid fines of $50 per MPG for each car sold that did not meet the 27.5 standard. But it was very difficult to sell fuel efficiency in the face of sharply falling gasoline prices. Cars designed for gasoline prices expected to reach $1.50 to $2 per gallon are not the ones that consumers want when the price of gasoline falls below $.80 per gallon.

It surprised no one when in 1986 Ford and General Motors petitioned the Department of Transportation for relief from CAFE. The Reagan DOT responded by lowering CAFE to a 26 MPG standard for the 1987–1988 model years and 26.5 MPG for 1989. This year, however, in an obvious surrender to the environmentalists, Transportation Secretary Skinner has raised the CAFE standard back to 27.5 MPG. It is once again popular to preach frugality in energy consumption, and Secretary Skinner was not one to buck this trend.

The irony of mandated fuel economy standards is that they may actually *increase* fuel consumption. First, it must be understood that CAFE is an exercise in reducing the attractiveness of new cars to consumers. CAFE standards are met in three ways—by reducing weight, by reducing engine displacement, and by spending money on new design and engineering. When gasoline prices are low, the first two strategies (which have contributed about 60 percent of the improvement in fuel economy) simply reduce the demand for new vehicles as older, heavier, more powerful cars are kept in use longer with these lower gasoline prices. The third strategy raises vehicle prices by more than it raises vehicle *value* because consumers do not desire these increases in fuel economy.

Proponents of CAFE would have us believe that the country is made better off by having producers offer a mix of cars to consumers that is less desirable than they would otherwise be offered. These advocates fail to understand that consumers will react by buying fewer new cars and keeping old gas-guzzlers longer. It is hardly surprising that in the face of the emissions, safety, and fuel-economy regulatory requirements that have been piled on new cars, the average age of cars on the road has increased by two full years since the mid-1960s. Peak demand for new cars in the 1980s was no higher than in the early 1970s, despite higher real GNP and the larger population.



Drawing by Cullum; Copley News Service.

The second reason why CAFE may actually increase total fuel consumed is that producers faced with a CAFE constraint may reduce the price of small cars to meet CAFE and thereby offset some of the deleterious effects of regulation of new car sales. If these inexpensive, smaller cars induce increases in vehicle miles travelled, the improvement in CAFE will be partially offset.

Third, if the overall mix of new cars sold is more fuel efficient, those new cars sold may be driven more miles because their greater fuel efficiency reduces the marginal cost of a vehicle mile.

In summary, CAFE has had much less effect on total fuel consumption than a simple examination of new-car fuel-economy trends might suggest. Unfortunately, no one has conducted a definitive empirical study of CAFE's effects that would give us a respectable estimate of the fuel saved. As in most environmental issues, this absence of evidence on the effects of policy simply allows proponents to press for even more stringent regulation.

Why, one might ask, do those who would defend us from Arab oil embargos, greenhouse warming, or other assorted prospective disasters not simply lobby for higher gasoline taxes? Surely, the real culprit in stimulating consumption of motor fuel is not Detroit engineering but low real gasoline prices. A sharp increase in the tax on gasoline would reduce fuel consumption,

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induce producers to design more fuel-efficient cars, and cause consumers to scrap their remaining pre-1980 cars at record rates. New-car sales would probably increase for several years even though higher gasoline prices would ultimately reduce the desired vehicle stock.

There are three arguments—now two arguments—against using a gasoline tax to reduce U.S. fossil-fuel consumption. The first is Bush's "read my lips" pledge, which obviously is no longer a binding constraint. The second is the fear that gasoline taxes are regressive, but surely CAFE is also regressive. It reduces economic welfare by an amount that rises less than proportionally with income. (Automobile-related expenditures do not rise proportionally with income.)

The third reason energy-regulation advocates may wish to avoid increasing gasoline taxes is that such taxes are simply too visible to consumers who will understand that government is forcing them to pay for a social objective with which they may or may not agree. Proponents of CAFE correctly perceive that it would take a large increase in gasoline taxes to achieve 27.5 MPG. It is not surprising, therefore, that they prefer to place the onus on the automobile companies and to pretend that consumers will not have to pay for this policy in terms of higher car prices or reduced vehicle performance.

As the drive to reduce fossil-fuel consumption heats up in the drive to combat global warming, advocates of fuel-economy regulation are now proposing new and more virulent forms of CAFE in the name of "carbon dioxide" regulation. These new proposals also generally include a subtle form of trade protection under which Japanese car companies would be forced to achieve a higher standard than U.S. companies.

Under the current CAFE program, full-line vehicle manufacturers are more constrained than those that specialize in smaller cars. Since there are no American small car specialists, it is easier for importers—principally Japanese companies—to meet CAFE requirements than it is for U.S. domestic producers.

Under the CAFE program, companies are permitted to carry forward any excess they achieve over the 27.5 MPG as potential offsets against future shortfalls. They are also permitted to carry back any excesses to make up for past shortfalls. At present, the Japanese companies have large carry-forward credits, while GM and Ford have deficits to make up from future surpluses. This situation has encouraged the Japanese companies to compete in the U.S. market for large cars, because U.S. manufacturers have to compromise on their large-car designs to meet and even exceed CAFE, while the Japanese do not even have to meet the standard for three years because of their accumulated credits.

Because a company's import and domestic fleet are regulated separately under CAFE, a company may not import small cars to offset its domestic production of gas guzzlers. (A domestic car is defined as one with 75 percent domestic content.) Because Ford has had difficulty achieving 27.5 MPG and is successful in marketing large cars, such as the Crown Victoria and the Lincoln Town Car, it is now moving to import slightly more than 25 percent of the value of its Crown Victoria line so that this low MPG car can be counted as an "import" for CAFE. This will reduce Ford's import CAFE rating—which is already far above 27.5—but raise its domestic rating.

The Japanese, meanwhile, are producing more of their small to midrange cars in the United States while using their credits on their imported vehicles to develop sleek, powerful new luxury cars for production in Japan and export to the United States. These cars have V-8 engines and much lower CAFE ratings than the usual Japanese car. The U.S. companies—particularly GM and Ford—cannot respond freely with more powerful versions of their own cars because of CAFE. Thus, the Japanese are being invited to compete in the highly profitable large and luxury car segments of the market by our own "conservation" policies.

The answer from U.S. politicians, obviously encouraged by U.S. producers, is to recast CAFE as a program that demands *proportional improvements* in fuel economy by all producers, not a flat standard. Japanese companies would then be forced to improve their fuel economy from their current average of about 30 to 31 MPG while Ford and GM might have to show a similar proportional improvement from about 26 to 27 MPG. Trade lawyers are now busy studying such an idea to determine whether it is consistent with the General Agreement on Tariffs and Trade.

Other proposals for extending fuel economy regulation of new cars are also being considered. Producers could be given credit for producing cars that use alternative fuels—particularly if those fuels, such as ethanol, are produced by

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U.S. farmers for automobile technologies that are unique to U.S. automobile companies. Or credits could be given for other greenhouse-gas savings activities, such as forest preservation, company car pools, or the repurchase of older cars for scrap.

There is yet another irony in the evolution of CAFE policy. The Department of Transportation is responsible not only for setting CAFE policy but also for regulating automobile safety. Since CAFE induces producers to offer more small cars and to reduce the weight of all of their models, CAFE increases highway fatalities. In its recent decision to raise CAFE back to 27.5 MPG, DOT found it expedient to reject claims that smaller cars are less safe, but in earlier proceedings involving safety regulation it had acknowledged just such a relationship. DOT's only defense in 1990 was that *"regulatory-induced"* reductions in automobile size do not increase highway fatalities, but apparently market-induced reductions do. John Graham and I have estimated that at its current level, CAFE could be responsible for a 14 to 27 percent increase in highway fatalities at current gasoline prices, once these CAFE-constrained cars fully penetrate the vehicle fleet. These findings have been disputed, of course, because government could not possibly be guilty of generating unintended consequences. Could it be that only markets fail, not legislators and regulators?

Robert W. Crandall
The Brookings Institution

P.S. In the last days of the 101st Congress, the CAFE bill died, and the gasoline tax was increased by five cents per gallon.

A Century of Antitrust: The Lessons, The Challenges

On July 2, 1990, the United States observed the 100th birthday of antitrust law, an occasion that led to a number of conferences and seminars at economics meetings and law schools across the country. Antitrust scholars would have been busy this year anyway. The key Bush antitrust officials—Janet Steiger at the Federal Trade Commission and James Rill at the Justice Department—spent their first year in office sending a clear message that the Bush antitrust "philosophy" is different from that of the Reagan administration. Economic efficiency in the creation, production, and delivery of goods is no longer the primary concern. Kevin J. Arquit, director of the FTC bureau of competition has been quoted as suggesting instead that "the idea is to prevent wealth transfers from consumers to producers."

On April 11 and 12, 1990, the Cato Institute sponsored its first annual *Regulation* conference, "A Century of Antitrust: The Lessons, The Challenges." The conference offered an opportunity to evaluate the history of antitrust, to consider current enforcement practices and points of controversy, and to look to the future of antitrust. Unfortunately, space limitations make it impossible for us to reprint here all the worthwhile papers and comments presented at the conference, but a sampling of the papers forms the basis of this issue.

The opening panel looked to the origins of antitrust and the historical enforcement record. Thomas DiLorenzo, whose article appears in this issue, opened the conference by arguing that, from the beginning, the antitrust laws were intended to protect favored producers.

In the Winter 1990 *Cato Journal,* Robert Bradley suggested another political motive for the Sherman Act. According to Bradley, Senator John Sherman's drive to become the 1888 Republican presidential nominee was blocked at the convention by Russel Alger, head of Diamond Match Company, an organization destined to become the target of a government investigation soon after the Sherman Act became law. Indeed, upon signing the Sherman Act, President Benjamin Harrison observed, "John Sherman has fixed General Alger." So much for protecting the little guy.

At the April conference, Dominick Armentano recounted a history of antitrust enforcement that has systematically undermined competition and efficiency. Armentano blamed this record of policy failure on the acceptance by antitrust enforcers and judges of the "perfect competition" model as a desirable policy goal. Armentano's Austrian-based critique of the "structure-conduct-performance" paradigm charged that the resulting models are too static, that they fail to make adequate allowance for the dynamic nature of market processes and adjustments. Armentano concluded that "the essence of the 'monopoly problem' is not to be found in free market

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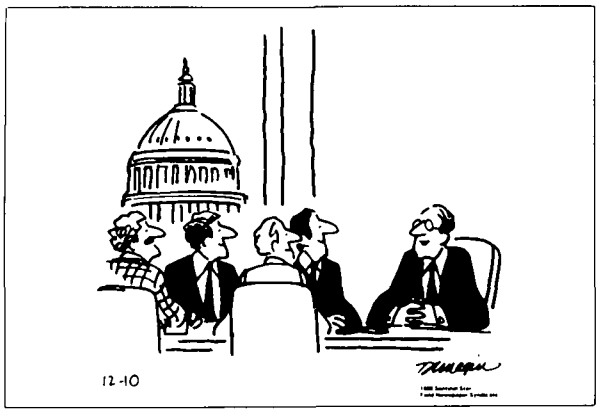

"SMALL BUSINESSES ARE THE BACKBONE OF THIS COUNTRY, GENTLEMEN... AND IT HAS BEEN OUR REGULATIONS THAT HAVE MADE THEM SMALL!"
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agreements, but in government *legal* impediments to rivalry (entry) or cooperation. Legal barriers to entry and prohibitions on interfirm cooperation prevent the market from generating, disseminating, and using information that traders require for efficient plan coordination."

George Bittlingmayer considered the macroeconomic impact of antitrust policy. Bittlingmayer presented evidence indicating that during the late nineteenth and early twentieth centuries, increases in antitrust enforcement tended to drive capital investment offshore: "Swings in antitrust enforcement caused major fluctuations in the economy during the first 25 years of the Sherman Act." Bittlingmayer noted, "Regardless of one's view of Standard Oil and the other larger firms and cartels, the periods of aggressive antitrust enforcement can be viewed as attacks on the existing organization of business." Bittlingmayer concluded by urging politicians to pay closer heed to the fallout from politically charged economic policies in the future.

The historical analysis of antitrust law and politics was concluded by luncheon speaker, James C. Miller III. Miller described and defended the goals and accomplishments of the Reagan administration's antitrust policies.

The second and third conference panels examined questions of current policies and areas of controversy. Steven Calkins and Frederick Warren-Boulton described how the Bush administration's approach to antitrust differed from that of the Reagan administration. In describing Bush's "kinder and gentler" antitrust policies, Calkins and Warren-Boulton observed that "part of the explanation is in the appointments. Jim Rill and Janet Steiger are less ideological than Bill Baxter and Jim Miller. Neither Rill nor Steiger is an economist. . . . Rill is a conservative with a litigator's heart, quite unlike his predecessors." The result is more active and potentially innovative antitrust policies. The Justice Department's new perspective was made apparent this past spring when Rill announced that he would consider prosecuting U.S.-based subsidiaries of firms engaged in anticompetitive actions overseas. (Michael DeBow discusses Rill's extraterritorial antitrust policies in a following Current.)

More specific issues were then addressed. Thomas Jorde and David Teece, whose paper is included in this issue, analyzed the impact of antitrust laws on innovation. After examining the innovative process, Jorde and Teece concluded that recent antitrust revisions designed to facilitate cooperative research and development ventures have not gone far enough.

The whole area of horizontal agreements is becoming more important, not only in research and development, but also for industries in which customers benefit from networking. Travel agents and their customers gain from access to a single source of information about competing flights and prices. Banking customers profit from shared ATMs that allow access to their money through other banks' machines. But the arrangements necessary to provide this kind of information and access also raise traditional antitrust concerns about possible agreements on prices and available services.

James Langenfeld described the FTC's approach to the gray area of horizontal agreements that on their surface are neither legal nor illegal per se. Langenfeld outlined the sequential analytical filters that the FTC uses in its attempt to determine whether specific horizontal agreements are likely to have important anticompetitive consequences. He then used as a specific example of the FTC process the decision to press the case against Detroit automobile dealers who had agreed on hours and days of operation. Langenfeld concluded, "Some agreements will usually be procompetitive, and those that would challenge such agreements should bear the burden of proof under a rule-of-reason standard. Other agreements may be better left illegal per se. Between these two extremes exists a 'gray area' where judicial efficiency suggests the need for a systematic approach to agreements among competitors. . . . The FTC's methodology focuses

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the inquiry on an efficiency rather than a market power screen."

Fred McChesney charged Chicago-school economists and lawyers with inconsistency in their continued support for limited antitrust. He argued that the Chicago school's "positive approach to antitrust as public-interest government intervention intended to correct market failure squarely contradicts the now-dominant economic theory of regulation that Chicago itself popularized. That is, the Chicago school of antitrust regulation runs counter to the Chicago school of regulation more generally." McChesney noted that antitrust regulation is no more likely to be used in consumers' interest than any other form of economic regulation, and he challenged Chicago-based opponents of repeal to reevaluate their positions.

William Shughart, in an article appearing in this issue, examined the role played by private litigants in the enforcement of the antitrust laws. Shughart concluded that the potentially substantial benefits that are possible through pursuit of private antitrust suits may often make litigation a profitable alternative to more traditional competition.

Rick Rule discussed antitrust policies toward vertical agreements. Rule concluded that vertical agreements are very often driven by efficiency concerns and that it is "not clear that in and of themselves, vertical restraints should ever be illegal." At worst, they may be evidence of some other antitrust violation that can be dealt with separately. (For a similar discussion, see Frank Mathewson's Current in this issue on legislative attempts to outlaw resale price maintenance.)

Donald Boudreaux, whose paper also appears herein, examined emerging theories of nonprice predation and raising rivals' costs. He argued that such theories, though interesting, appear to have little basis in fact if one accepts that the "perfect competition" model has little to say about real-world rivalry.

William Kovacic considered how Reagan's judicial appointments would affect antitrust policy in the 1990s. Kovacic began by noting that "since 1890, the comparatively open-ended language of the principal antitrust statutes has given federal judges a crucial role in determining the content of the statutes' competition commands." In fact, a growing judicial appreciation of economic criticisms of past antitrust policies aided Reagan appointees Bill Baxter and Jim Miller in their efforts to change the direction of antitrust in the early 1980s. Kovacic concluded that Reagan's impact on antitrust may continue to be felt long into the future through his judicial appointments: "Amid signs of a limited revival of antitrust approaches the Reagan administration disfavored, [judicial] appointees of the Reagan and Bush administrations will play a major role in determining how far the antitrust pendulum swings back toward its pre-Reagan equilibrium."

A similar viewpoint recently appeared in the *Wall Street Journal*. In an August 6, 1990, article entitled, "Bush's Plan to Prosecute Antitrust Cases Could Fail Because of Reaganite Judges," reporter Paul M. Barrett began, "Fans of old-time aggressive regulation of corporate mergers celebrated the Bush administration's early declarations that the antitrust cops were back on the beat. . . . But free-market rumblings from two influential federal appeals courts may foreshadow hard times for antitrust enforcers who back their rhetoric by bringing lawsuits." Barrett continued, "Legal scholars observe that Reaganite hostility to the very idea of merger enforcement has become increasingly fashionable among sitting federal judges." As an example he quoted Judge Alex Kozinski, who wrote in a recent decision, "The market has its own fail-safe mechanisms. . . . More fundamentally, in a free economy the market itself imposes a tough enough discipline on all market actors, large and small."

Henri Lepage broadened the context of the American debate by providing a description of evolving European competition policy. European "antitrust" policies have been strengthened of late. Lepage identified several reasons for this. For example, the EEC Commission seeks to help Europe improve the productivity of its industries. Lepage noted that the commission believes this can be achieved "by a policy that will discriminate between mergers that allow more economies of scale to be captured and mergers whose aims are only to strengthen monopolistic market positions." But, Lepage warned, "This is precisely the kind of knowledge that no one can obtain without the discovery process of an unhampered market." Lepage concluded that while the fall of communism in Eastern Europe was to be applauded, "many journalists are too quick to proclaim the final victory of

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capitalism. The next few years may bring about an unexpected revenge of statism under two guises: that of 'saving the earth' and 'saving competition.' Statism will change its traditional clothes, but it will still be statism."

Finally, Judge Douglas Ginsburg responded to earlier charges that Chicago-school adherents are inconsistent in their approach to antitrust regulation. Ginsburg framed his remarks by identifying the types of business behavior that should be prohibited from an efficiency point of view. He concluded that price-fixing and a few mergers are undesirable in a free-market economy.

The speakers at the conference generally agreed that past antitrust enforcement has often worked to the detriment of consumers and undermined the competitive process. But there was disagreement about whether the proper response was reform or repeal. There is little doubt, however, that antitrust scholars of all stripes will have much to study and debate in the coming decade. Even the gains from the Reagan administration seem by no means assured as the Bush administration's policies begin to take hold in the markets. Kevin Arquit of the FTC has declared, "I hope [the Sherman Act] lives on for another 100 years." Unfortunately, it probably will.

C.E.

Do Not Use U.S. Antitrust Enforcement to Promote U.S. Exports

The Antitrust Division of the U.S. Department of Justice is considering an important change in its international enforcement policies. The proposal is that the division should sue foreign firms that may have violated U.S. antitrust law through activities conducted outside the United States when those activities have adversely affected the ability of U.S. firms to export products to the country in question. If adopted, this practice would represent a dramatic and mistaken departure from Reagan administration policies, as it would reinstate the announced policies of the Carter administration Justice Department concerning extraterritorial antitrust enforcement.

The Reagan legacy, as applied to questions of international antitrust, is embodied in the "Guidelines for International Operations" adopted by the Antitrust Division in 1988. The guidelines describe the situations in which the division will exercise its prosecutorial discretion and bring suit over alleged antitrust violations in international trade. The guidelines are consistent with the Chicago-school view that the only legitimate goal of the antitrust laws is the protection of *consumer* welfare (as opposed to the protection of *producer* welfare). At the time of their adoption, then-Assistant Attorney General Charles Rule explained that the guidelines sought to "condemn only those practices that threaten to raise prices or reduce output to U.S. consumers." The guidelines themselves make this point repeatedly, as in the declaration that the Antitrust Division "is concerned about transactions and conduct" that have adverse "effects on competition, rather than competitors."

The proposed international enforcement policy now under consideration by the Antitrust Division would scrap the consumer welfare orientation of the current guidelines.

This extraterritorial antitrust proposal arose out of the Structural Impediments Initiative (SII), a series of talks between the U.S. and Japanese governments about the removal of alleged barriers to U.S. export penetration of Japanese markets. U.S. negotiators encouraged the Japanese government to take steps to remove or reduce such barriers, and in the June 1990 final report from the SII, the Japanese government pledged stricter enforcement of its own antitrust laws (themselves a U.S. export). The proposal now under consideration at the Antitrust Division apparently developed from a concern that the Japanese government will not do so much in the antitrust area as the U.S. government would like. The idea seems to be that if the Japanese government will not act, the U.S. antitrust authorities should.

The application of U.S. antitrust laws to actions taken largely (or entirely) in other countries has long been a complex issue, and it has, from time to time, generated much opposition from the United States' trading partners. The U.S. view of its courts' jurisdiction in such matters—which was codified by the Foreign Trade Antitrust Improvements Act of 1982—employs

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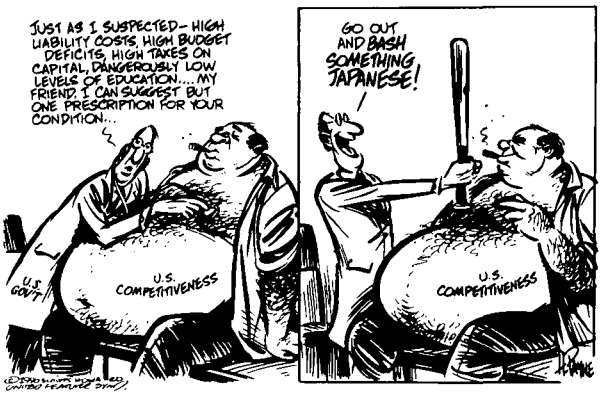
the "effects test." If actions taken overseas have a "direct, substantial, and reasonably foreseeable effect" on U.S. interests, then a U.S. court may properly exercise jurisdiction to hear the case. The flaws in the proposal now under review do not revolve around jurisdictional puzzles or questions of international law, however. The real problems with the extraterritorial antitrust proposal stem from the type of U.S. interests that would be protected through such lawsuits.

The proposed policy would be applied in situations where, by definition, the welfare of American consumers would not be the primary goal of antitrust litigation. This portion of U.S. antitrust enforcement, instead, would be engineered to protect the interests of U.S. *businesses.* (Indeed, as discussed below, antitrust suits designed to help U.S. exporters could well threaten U.S. consumers' interests.) At best, the extraterritorial antitrust policy under consideration would convert a portion of federal antitrust enforcement into a new type of export promotion program. At worst, it would undermine the Antitrust Division's domestic enforcement activities and lend support to those individuals in Congress, on the bench, and at the bar who wish to see antitrust used to pursue multiple goals. Two major points support this latter claim.

First, it would be difficult for the Bush administration to jettison the consumer welfare standard in the international realm and to adhere to it in the domestic realm. The problem is not merely one of logical inconsistency. Such a posture would likely be attacked both politically and judicially.

In antitrust politics a new export-promotion goal in international enforcement would undercut the administration's credibility and effectiveness in making consumer welfare-based arguments against alternative antitrust policies. For example, the administration has, to date, successfully opposed congressional efforts to reverse several recent Supreme Court decisions in the vertical restraints area that displease some retailers. The consumer-welfare-based analysis that informs the current administration's opposition—as well as the opposition of the Reagan administration—is the most intellectually coherent defense of the doctrines that some in Congress wish to overturn. (See the following Current by Frank Mathewson.) The Bush administration's opponents are not likely to accept the


JUST AS I SUSPECTED- HIGH LIABILITY COSTS, HIGH BUDGET DEFICITS, HIGH TAXES ON CAPITAL, DANGEROUSLY LOW LEVELS OF EDUCATION.... MY FRIEND I CAN SUGGEST BUT ONE PRESCRIPTION FOR YOUR CONDITION...
U.S. GOVT
U.S. COMPETITIVENESS
GO OUT AND BASH SOMETHING JAPANESE!
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position that the antitrust laws mean one thing (promoting the welfare of U.S. consumers) when applied in a domestic setting while they mean quite another (promoting the welfare of U.S. producers) when applied to foreign defendants.

By embracing producer welfare in the international realm, the Antitrust Division would undermine the concept that consumer welfare is the sole appropriate goal of antitrust in domestic antitrust litigation. This is so, in part, because of the structure of the Foreign Trade Antitrust Improvements Act. This act is explicitly a jurisdictional statute; it does not define substantive offenses, but refers instead to the substantive offenses defined in the Sherman and Clayton Acts. Thus, an international antitrust enforcement regime that reads the Sherman and Clayton Acts as advancing producer welfare would, of necessity, read these acts as also protecting producer welfare when domestic behavior and defendants are involved.

There is a second way in which pursuit of an extraterritorial antitrust policy would undermine the remainder of the Bush administration's antitrust policies. If export promotion is a goal of federal antitrust enforcement, the Antitrust Division could attack foreign business methods that *promote* U.S. consumer welfare. Consider, for example, the case of U.S. firms that fail to make sales to Japanese manufacturers. Such failures are often blamed on the Japanese *keiretsu*—alliances of firms centered around either a bank or a major manufacturer. Fear of *keiretsu* recently led Rep. Jack Brooks to direct the FTC to investigate the purchasing practices of the Japanese auto manufacturers—and their failure to buy from U.S. suppliers. In the SII talks, the U.S. representatives (including Assistant Attor-

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ney General James Rill, head of the Antitrust Division) were clearly suspicious of the *keiretsu*, and the Japanese government promised to study antitrust compliance questions regarding *keiretsu* members.

Keiretsu can serve legitimate purposes, however. According to an article by Marie Anchordoguy in the July-August 1990 *Harvard Business Review*, a *keiretsu* led by a large bank "enable[s] companies to share risk and provide[s] a mechanism for allocating investment to strategic industries." "Supply *keiretsu*," on the other hand, "are groups of companies integrated along a supplier chain dominated by a major manufacturer." *Keiretsu* members typically engage in "mutual shareholding," the "purchase of a small amount of each other's shares, usually 2 percent to 5 percent," combined with a promise not to sell the stock. Accordingly, interlocking directorates are common. Also common, according to the U.S. representatives to the SII talks, is the refusal of firms that are members of *keiretsu* to buy from American suppliers. They prefer instead to deal with their *keiretsu* brethren.

Should the Antitrust Division seek to attack the Japanese *keiretsu* system through antitrust litigation? The supply *keiretsu* are a form of vertical integration, to many forms of which U.S. antitrust law was long hostile. Indeed, in the mid-1960s, the Supreme Court threatened to declare per se illegal nonprice vertical restraints, such as a supplier's territorial constraints. Recent decisions by the Court in this area have adopted a much more defensible approach to questions of vertical restraints, but these recent decisions rest primarily on a consumer-welfare standard. If this standard is jettisoned in the international arena, what standards would then be applicable, domestically or internationally?

Unfortunately, if antitrust is viewed as promoting producer welfare as well as consumer welfare, then the welfare of U.S. consumers would most likely suffer. Suppose that the Antitrust Division's hypothetical challenge to the *keiretsu* succeeds. If firms in a Japanese industry choose to organize in this fashion, and if they also gain a larger share of world markets, it is reasonable to conclude that this is a superior, more efficient way of organizing production.

Indeed, just such a conclusion is reached by Charles Ferguson of the MIT Center for Technology, Policy, and Industrial Development. In an article titled "Computers and the Coming of the U.S. *Keiretsu*" in the *Harvard Business Review*, Ferguson argues that the recent successes of Japanese computer firms can be traced in substantial measure to their *keiretsu* form of organization. He goes on to suggest that U.S. and European firms must emulate this example if they are to compete effectively. If the Japanese system is a superior form of organization, then attempts to protect U.S. suppliers through an antitrust assault on the Japanese computer *keiretsu* would risk serious damage to the interests of U.S. buyers of computers and other information-technology products. Clearly, U.S. suspicion of "foreign" forms of business organization combined with an antitrust policy that makes them targets of government-sponsored litigation may well prove counterproductive from the standpoint of U.S. consumers' welfare.

Private plaintiffs may also attempt to make the same arguments that the Antitrust Division is now considering. One hopes that the Antitrust Division would oppose the private suit if U.S. consumers' welfare would be harmed by interfering with foreign business practices. The Antitrust Division's ability to oppose such suits would, however, be diminished if it adopted the policy now under consideration. This is so largely because the policy would have the effect of legitimizing the private plaintiff's claim that the antitrust laws protect producer welfare.

The Antitrust Division's specialists in international enforcement are reviewing the proposal to use U.S. antitrust laws to promote U.S. exports. A decision will likely be announced before the end of the year. The decision will have a profound effect on the future of the idea that consumer welfare is the single legitimate goal of antitrust. This idea is invaluable in confining the law to its proper, limited role in the U.S.—as well as the international—economy. Although the past decade has seen federal antitrust enforcement policy and much case law based on the consumer welfare norm, it is still an open question whether this view is politically viable. The resolution of this seemingly narrow issue of international enforcement should give us some indication. The administration should decline this proposed new venture in U.S. antitrust enforcement.

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Resale Price Maintenance Revisited

Among other pieces of potential legislation percolating in the U.S. Congress are bills that will transform current U.S. common law on resale price maintenance into statutory law. Dissatisfaction with the Supreme Court's decisions in two recent cases, *Spray Rite* and *Sharp Electronics*, appears to be the catalyst for the current legislative push, championed in the past by Sen. Howard M. Metzenbaum and others. Whether the catalyst will prove sufficient to press the legislation through the Senate as well as the House remains to be seen. But the push seems to be stronger now than before. From the perspective of antitrust economics there are two questions of interest: Does the legislation promote economic efficiency? If not, what specifically accounts for the legislation? Or "whose ox is being gored"?

Recently, economic and legal scholars have written extensively about resale price maintenance (RPM) and the host of other possible vertical contractual restrictions between manufacturers or wholesalers and their downstream operators such as retailers or franchisees. A considerable body of learned opinion argues cogently that these practices, when observed, are likely to be efficient. In any case, it seems reasonable to apply to RPM the same rule-of-reason approach accorded to other possibly substitute instruments such as exclusive territories.

There is more than one possible role for RPM. The classic explanation involves a "free-ride" among retailers where point-of-sale information and service at the retail level are important to the sale of the product. The story is simple enough.

In a market where consumers require relatively extensive information before making a purchase or before using the product, a "free-rider" problem can develop if consumers go to a full-service store to obtain the necessary information but then purchase the product from a discount outlet that provides no information but offers a lower price. In the extreme, if the provision of information at the retail or wholesale level is essential to the development of a market or product, the failure of the full-service store to recover the cost of providing the information could lead to the collapse of the market. Manufacturers who can eliminate discounters by imposing price floors can guarantee a return to the full-service retailer and thus allow the market to develop. Whether RPM is necessary to ensure that valuable information is available in any particular case should be decided on the facts of that case. RPM would seem to make the most sense for complex products just introduced to or relaunched in the market.

In the case of *Spray Rite*, for example, Monsanto had responded to a drop in its market share of farm herbicides by initiating a program of point-of-sale information to farmers on the application and uses of its farm products. Monsanto claimed that Spray Rite did not adhere to the Monsanto plan, did not employ technically trained employees, and sold the product at discount prices. Other dealers complained to Monsanto. If the information program was important to the sale of the product, the associated disincentive created for other retailers by the discounter's failure to provide the information could jeopardize the market for Monsanto. The court upheld Monsanto's right to establish a price floor if Monsanto's decision were unilateral, but in this case the Court supported the district court jury's finding of a "common scheme" to set resale prices.

But RPM can enhance efficiency even when the apparent role for retailer information would appear to be minimal. For example, jeans have frequently been subject to RPM, yet retailers of jeans provide no important information role. Realistically, consumers do not try on jeans at high-service stores and then buy the jeans at discount stores. The interest of manufacturers in imposing RPM in such cases can be explained without the free-rider argument.

Retailers offer many nonprice services that encourage consumers to buy products. They display them for consumer inspection in pleasant and perhaps spacious surroundings. They offer demonstrations of the product's capabilities and attributes. They engage courteous sales people to accommodate consumers' search for products that meet their needs. And retailers affect the consumers' costs of purchasing a product by the length of the lines at cashiers' stations.

Manufacturers are interested in setting price *and* nonprice instruments to encourage consumers to purchase their products rather than those of their rivals. Manufacturers are less interested in which specific retail outlet the consumer chooses. Retailers, however, use both price and nonprice competition to encourage consumers to purchase a particular good at their outlet rather

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than at a competing outlet. The differences between the objectives of the manufacturer and the retailer or wholesaler in using price and nonprice instruments can lead to the use of RPM to align the interest of both parties.

The consumers that one retailer attracts away from another retailer have low average opportunity costs of time and search costs. (Busy people buy jeans from the nearest store and are less price conscious and more service conscious.) From the manufacturer's perspective, the retailer is overly concerned about consumers who have low search costs when it makes its pricing and nonpricing or service decisions because these consumers are overrepresented among consumers on the margin of buying between two retailers. The manufacturer focuses instead on consumers on the margin of buying his product instead of another product. These consumers are more concerned with the "nonprice" costs of buying the product. The manufacturer can help realign the retailers' incentives by constraining the extent of their price competition, which encourages more service competition.

The earlier example of point-of-sale information is one example of a retailer service, but it is not the only one. The use of RPM by a manufacturer in its retail contracts is by itself, no indication of a substantial lessening of competition. Subjecting virtually all such agreements to rules of per se illegality, which would be the case if the bills under current scrutiny become law, could therefore substantially reduce overall consumer welfare.

If RPM were per se legal, not all manufacturers would instantly choose to eliminate all discounters. Discounters could serve other roles, such as servicing the more price-sensitive segments of the market.

To serve consumers, then, competition policy must move away from the excessively rigid position associated with the type of bills currently being considered in Congress. The tests for the courts should be the facts in a particular application and the possible motivations for the practice.

In the *Spray Rite* and *Sharp Electronics* cases, the U.S. Supreme Court seems to be inching toward this position in an extension of the Colgate doctrine. Under this doctrine, manufacturers are free to select the type and nature of competition for their products at the retail level, provided that there is no conspiracy between the manufacturer and an existing retailer to eliminate a price-cutting retail competitor.

If the proposed legislation would lead to lower economic efficiency, why are the bills before Congress? One suggestion is that the recent advocacy position by the Antitrust Division of the Department of Justice (beginning with William Baxter's term as Assistant Attorney General) has incensed Congress, and the enhanced chances of the bills in Congress reflect increased congressional hostility toward the Antitrust Division's policies. Of course, this does not identify whose interests the bills would protect. If RPM did signal a horizontal price conspiracy across retailers or manufacturers, there is already obvious and ample legislation to protect economic efficiency. Those who would benefit from per se illegality of RPM do not appear to be so numerous or so important politically as to warrant this kind of attention.

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Stop Giving Away Airline Routes

Federal lands hold enormous deposits of oil, natural gas, silver, and other minerals. If the government one day were to announce that it would give an oil field to some private company without requiring any payment, the American people would react with outrage, and rightly so.

Now, let us turn the lens to international air services. International air passenger and cargo services are regulated by the national governments of the countries touched by the respective routes. Government regulation often results in high fares that in turn are supported by limits on capacity and frequency of flights. These high fares translate into substantial profits for airlines fortunate to receive the right to operate. Some measure of these profits may be gleaned from the price of $750 million paid by United Airlines to Pan American's Pacific Division for aircraft and route authorities in 1985, and Eastern Airlines' recent sale of its Latin American routes to American Airlines for $349 million.

Clearly, international air routes can be as profitable as oil, gas, or silver deposits. But the fed-

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eral government chooses to treat them very differently. Companies must pay to extract oil from federal lands. In contrast, no airline has ever paid a penny to the federal government for rights to international air routes.

A simpler, fairer, and more efficient method would be to allocate rights to new routes by open tender. The airline that believes that it can provide the most competitive product—in terms of service and price—would bid highest and win the auction. If market forces prove management wrong, or if competitive conditions change, the airline should be allowed to sell the route authority to another operator. Put simply, the federal government should not treat international air routes differently from other federal property such as undeveloped land, timber, or vehicles seized from drug traffickers.

Under the present system, the initial recipient of route authority pays nothing to the government. This means, of course, that airlines compete for the rights in other ways. I do not doubt that airlines have spent large sums on lawyers, lobbyists, and influence to obtain routes. Last November, the federal government concluded a new air services agreement with Japan that Secretary of Transportation Samuel Skinner hailed as providing "the most dramatic expansion of air services to Japan since the original bilateral aviation agreement was signed in 1952." The agreement triggered a scramble among U.S. airlines, including American, Delta, Northwest, and United, for new routes, which Assistant Secretary of Transportation Jeffrey Shane estimated would take *twelve months* to allocate. Without doubt, an abundant harvest for Washington lobbyists!

And they are not the only beneficiaries. It is said that the Department of Transportation prefers airlines to serve long international routes with Boeing 747s. Should the airlines not be allowed to decide such questions?

The current system also engenders other inefficiencies. Presently, DOT must approve all transfers of routes between airlines. The department is said to question whether routes should be sold by one carrier to another.

Inefficiencies arise wherever property rights are not well defined or secure. Livestock farmers systematically overgraze common pasture; Hong Kong residents are transferring their assets to avoid expropriation by the Peoples Republic after 1997. Similarly, an airline whose claim to a route is uncertain will be discouraged from long-term investment. American managers are often criticized for being myopic. International air services are an example where short-term thinking results directly from ambiguity in government regulation. The remedy is simple—remove the regulator's discretion.

DOT might argue that assignment of routes by administrative fiat allows the department to prevent any one airline from building up monopoly power over international air services. The auction method that I propose does not prevent DOT, or the Justice Department for that matter, from regulating which airlines should be allowed to participate in an auction. If either agency judged that market competition might be jeopardized, it could, of course, disqualify particular airlines from bidding. Likewise, the federal and state governments could review all subsequent transfers of routes, just as they do under existing antitrust laws in many other markets.

Allocation by auction, however, does force all government decisions out of the recesses of dimly lit corridors and smoke-filled rooms into the clear light of day. It forces airlines to compete for rights to a valuable asset in the most efficient way possible, and moreover, to use the asset efficiently. Finally, the auction method clearly defines the property right and thereby fosters long-term investments.

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Higher Budgets for Federal Regulators

When former President Reagan came to office nine years ago, he promised to get the government off the backs of Americans. One of the tools applied to this ambitious task was to tighten the purse strings of the federal regulatory agencies.

But the first solo budget of President Bush sends a different message—"happy days are here again" for federal regulators. Much can be inferred about President Bush's view of the federal regulatory apparatus from an analysis of his proposed 1991 budget.

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Bush Budget Breaks from the Recent Past

Spending by the federal regulatory agencies will reach a record high in 1991—both in current dollars and in real terms. Expenditures will total nearly $12.25 billion, up 9 percent in nominal dollars and 4 percent after adjusting for inflation.

Last year's budget (primarily prepared by Reagan holdovers), by contrast, called for only a 2 percent nominal increase in regulatory spending. After adjusting for inflation, real spending was slated for a 1 percent cut. Interestingly enough, after Congress and the Bush administration massaged the 1990 budget, federal regulators gained a great deal of purchasing power. Spending plans increased from $10.98 billion to $11.26 billion, thus changing a proposed cut in real spending to an actual increase.

Similarly, President Bush appears more inclined to allow the federal agencies to increase their employment than was his predecessor. Regulatory staffing is estimated to rise by 4,300 people from 1990 to 1991—a 4 percent increase. Nonetheless, the total of 113,300 is still well below the peak of 118,800 reached in 1980 at the end of the Carter years.

Reagan's regulatory reform strategy included hefty personnel reductions. Regulatory staffing dropped by 15 percent from the 1980 high to 101,300 in 1985. In his second term, Reagan allowed modest staff growth—about 1 percent a year. In addition to planning for a much larger increase in 1991, Bush is permitting the agencies to add 2,000 more staffers in 1990 than the previous administration had planned. Thus a 3 percent growth in federal regulatory personnel in 1990, followed by a 4 percent increase in 1991, signals a significant departure from the game plan of the past.

In short, President Bush appears less skeptical about the role of federal regulators in the U.S. economy. He is willing to provide more resources—dollars and staffing—to these efforts than was Reagan. Indeed, he has proposed a growth path for regulatory budgets and staffing that looks similar to the budget trends of the Carter years.

Focus on the Environment

Bush's pledge to be the "environmental president" and the continuing high level of public

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support for environmental controls virtually assures the Environmental Protection Agency its place at the top of the federal regulatory agencies for the foreseeable future. The EPA budget (excluding construction grants) accounts for nearly one-third of the total expenditures for 1991 at the federal regulatory agencies. EPA is slated for a $360 million budget increase in 1991, following a $310 million rise in 1990. This 20 percent boost over two years is substantially above the average 16 percent increase in total regulatory expenditures.

EPA staffing has also grown dramatically during the past twenty years. The head count has increased from 3,900 in 1970 to 15,300 in 1990. The new Bush budget allows for an additional 900 employees, which will bring the total to 16,200. By the end of 1991, EPA staffing will account for 14 percent of the total for federal regulatory agencies. The two Bush budgeting periods have resulted in an overall projected staffing increase of 16 percent at EPA, well above the 7 percent overall increase in federal regulatory personnel.

A Rising Tide Lifts (Nearly) All Boats

Tables 1 and 2 provide summary information from the 1991 budget as well as some historical figures to put the new numbers in perspective. Table 1 shows that budgets are growing in real terms in every subcategory except energy. This does not mean that every agency is growing, but it does indicate that many different types of regulatory activities are expanding.

Overall, budget gainers in the 1991 budget outnumber losers by 32 to 19. Growth in real spending is a widespread phenomenon. Our re-

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Table 1: Summary of Administrative Costs of Federal Regulatory Activities (fiscal years, dollars in millions)

Agency	1970	1980	1989	(Estimated) 1990	1991	% Change 1990–1991	1970	1980	1989	(Estimated) 1990	1991	% Change 1990–1991
	Current Dollars						Constant 1982 Dollars					
Social Regulation												
Consumer Safety and Health	710	2,354	3,185	3,476	3,804	9	1,524	2,730	2,513	2,637	2,770	5
Job Safety and Other Working Conditions	128	753	959	998	1,060	6	274	873	757	757	772	1
Environment	214	1,651	3,904	4,185	4,485	7	459	1,915	3,081	3,175	3,267	3
Energy	64	550	449	484	501	4	137	638	354	367	365	−1
Total	1,116	5,308	8,497	9,143	9,850	7	2,394	6,156	6,705	6,936	7,174	3
Economic Regulation												
Finance and Banking	87	362	1,067	1,073	1,218	13	187	420	842	814	887	8
Industry-Specific Regulation	91	279	301	321	346	7	195	324	238	244	252	3
General Business	115	354	693	723	832	15	246	410	547	548	606	10
Total	293	995	2,061	2,117	2,396	13	628	1,154	1,627	1,606	1,745	8
Grand Total	1,409	6,303	10,558	11,260	12,246	9	3,022	7,310	8,332	8,542	8,919	4

Source: Center for the Study of American Business, Washington University. Derived from the Budget of the United States Government and related documents, various fiscal years.

port for the Center for the Study of American Business—*Regulation's Rebound*—provides detailed data on individual agency spending and staffing. A few highlights from this more detailed analysis are worth sharing in this brief overview.

A general principle, borne out by the 1991 budget, is that regulatory growth often follows salient news events. Coast Guard budgets benefit from oil spills; Food and Drug Administration spending rises to handle increased pressure for new AIDS drugs and charges of alleged quality problems for generic drugs; financial regulators are added to respond to concerns about instability in the financial markets; and Federal Aviation Administration budgets climb in the face of concerns about airline equipment and personnel readiness.

"Consumer safety and health" is receiving an added boost due to large increases at the FDA,

Table 2: Staffing Summary for the Federal Regulatory Agencies (fiscal years, permanent full-time positions)

Agency	1970	1980	1989	(Estimated) 1990	1991	% Change 1990–1991
Social Regulation						
Consumer Safety and Health	41,613	54,591	44,888	46,040	47,973	4
Job Safety and Other Working Conditions	7,472	18,201	14,768	14,705	14,899	1
Environment	4,241	14,318	17,840	19,441	20,258	4
Energy	688	5,303	3,380	3,293	3,301	0
Total	54,014	92,413	80,876	83,479	86,431	3
Economic Regulation						
Finance and Banking	6,219	9,681	10,881	10,747	10,884	1
Industry-Specific Regulation	6,072	7,365	4,708	4,770	4,798	0
General Business	7,070	9,390	9,392	10,015	11,198	11
Total	19,361	26,436	24,981	25,532	26,880	5
Grand Total	73,375	118,849	105,857	109,011	113,311	4

Source: Center for the Study of American Business, Washington University. Derived from the Budget of the United States Government and related documents, various fiscal years.

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FAA, and the Agricultural Marketing Service. This category of regulatory activity shows a 9 percent growth in the Bush budget. Staffing levels are also growing substantially. The FDA and FAA personnel totals will increase in 1991 by 9 percent and 6 percent, respectively.

Budget increases for the Patent and Trademark Office and the Securities and Exchange Commission cause the largest subcategory growth in "general business." Spending in this area is increasing by 15 percent in nominal terms and staffing is going up 11 percent. Once again, these increases are not surprising. The concern about protecting intellectual property rights is helping the Patent and Trademark Office to increase its budget by 21 percent and its staffing by 22 percent. The frequent Wall Street scandals and the junk bond crisis are leading to changes at the SEC that justify a 16 percent budget increase and personnel growth of 6 percent.

Many smaller agencies also show significant budget increases on a percentage basis that indicate growing concern for specific issues. The Drug Enforcement Administration, Labor-Management Services Administration, Farm Credit Administration, Commodity Futures Trading Commission, and the Copyright Office are examples.

The Changing Composition of the Regulatory Pie

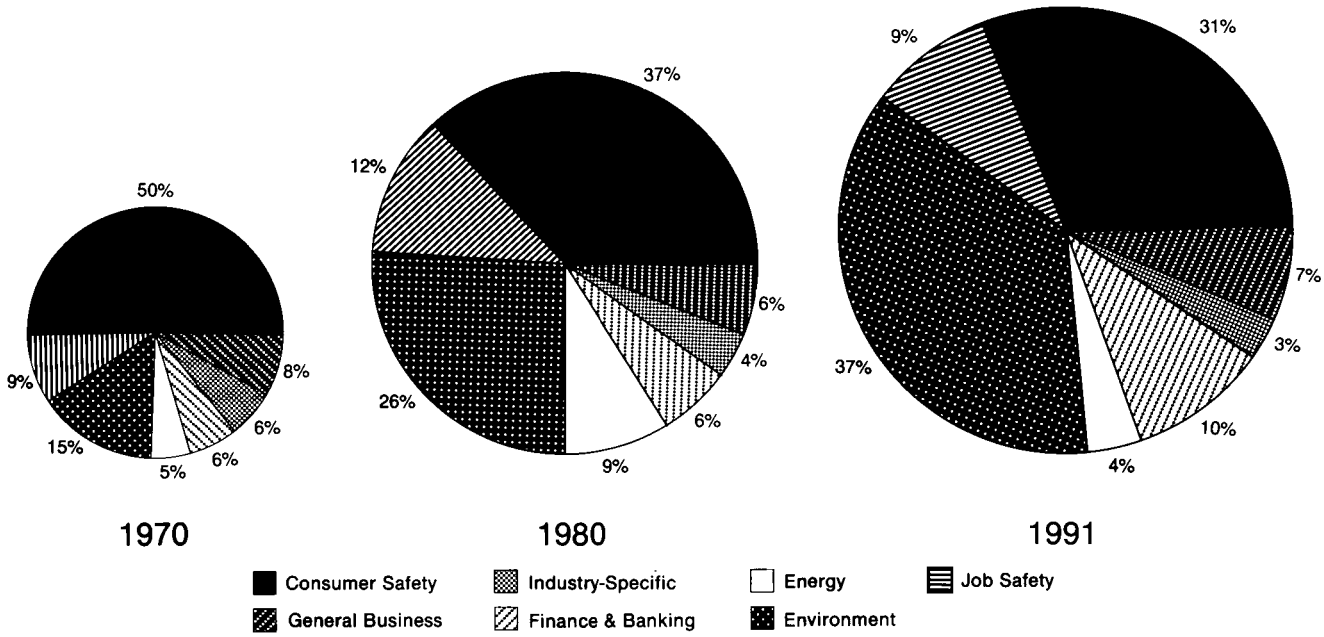
Figure 1 shows how the division of the spending pie has changed over the past 20 years. The size of the "pies" in the figure are also proportional to real spending totals. Clearly, spending priorities have undergone significant changes during the past two decades.

First, environmental expenditures (excluding EPA construction grants) accounted for only 15 percent of federal regulatory spending in the inaugural year of the EPA. A decade later, environmental administrative costs claimed 26 percent of total expenditures. The Bush budget for 1991 would give environmental concerns 37 percent of the total.

On the other hand, spending for "consumer safety and health" has been shrinking in relative terms over this period. Half of federal regulatory expenditures were in this area in 1970, declining to 37 percent in 1980 and falling further to 31 percent of the 1991 budget.

This declining share of the spending pie is primarily the result of lower than average spending growth at the old-line agricultural inspection services within the Department of Agriculture. In real terms the Consumer Product Safety Com-

Figure 1: Changes in Real Spending Shares



Source: Center for the Study of American Business, Washington University. Derived from the 1970, 1980, and 1991 Budgets of the United States Government.

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mission budget has declined nearly 50 percent since 1970. Higher growth rates at the FAA and FDA have failed to balance below-average increases at the other agencies included in "consumer safety and health."

Economic deregulation has had a mixed effect. As Figure 1 shows, "industry-specific" regulation (primarily in the transportation industry) is steadily shrinking. This area went from 6 percent of the pie in 1970 to 4 percent in 1980 to 3 percent in 1991. But deregulation in finance and banking has actually led to a *larger* share of regulatory spending in this area—from 6 percent of the 1970 budget to 10 percent in 1991. The continuing federal insurance of deposits and an active role in assuring confidence in financial markets explain this apparent anomaly.

Energy market regulation has grown and then contracted during this period—a reflection of changing views of the effectiveness of the marketplace vis-à-vis direct government controls. Energy regulation in 1970 consisted of Nuclear Regulatory Commission (Atomic Energy Commission) restrictions on nuclear power plants. With the establishment of the Department of Energy, the proportion of regulatory expenditures going to this subcategory grew from 5 percent to 9 percent in 1980. Deregulation of petroleum and natural gas since then has shrunk "energy" spending to 4 percent of the total.

Conclusion

Analyzing the spending and staffing plans for the 51 major federal regulatory agencies is admittedly an exercise in reading tea leaves (or perhaps the entrails of a goat). The figures provide a crude measure of the ebb and flow of federal intervention in various areas of the private sector. Of course, it is not the administrative cost of regulation that reflects the primary impact on the economy but rather the multiplier effect of regulatory agency activities on compliance costs borne by business firms and ultimately by consumers.

Analysts are on firmer ground when inferring meaning from two decades of data than they are when analyzing just two budget periods. The rising importance of environmental issues is a clearly established phenomenon. Apparent across-the-board support for federal regulations shown in President Bush's 1991 Budget may or may not prove to be an enduring feature of administration budgets, however. But for now it seems safe to conclude that regulation is on the rise in the U.S. economy.

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The Origins of Antitrust

Rhetoric vs. Reality

Thomas J. DiLorenzo

Today regulation is generally recognized as a mechanism by which special interests lobby the government to create barriers to entry or other special privileges. Research has shown, for example, that the Civil Aeronautics Board cartelized the airline industry, the Interstate Commerce Commission helped monopolize the railroad and trucking industries, the Federal Deposit Insurance Corporation sharply limited entry into the banking business, and occupational licensing created entry barriers into hundreds of occupations. Much of the history of regulation chronicles monopoly privileges procured through the auspices of the state, as Adam Smith pointed out more than 200 years ago in *The Wealth of Nations*.

Oddly, antitrust regulation is still widely viewed as government's benevolent response to the "failures" and "imperfections" of the marketplace. Even economists who are usually skeptical of regulations enacted in the name of the public interest seem to lose their perspective when it comes to antitrust. George Stigler, for example, has stated: "So far as I can tell, [the Sherman Act] is a public-interest law . . . in the same sense in which I think having private property, enforcement of contracts, and suppression of crime are public-interest phenomena. . . . I like the Sherman Act."

A 1984 survey of professional economists revealed that 83 percent of the respondents believed that "antitrust laws should be used vigorously to reduce monopoly power from its current level." This opinion is widespread despite common knowledge among antitrust scholars that in practice the antitrust laws restrain output and the growth of productivity, have contributed to a deterioration of the competitive position of U.S. industry, and are routinely used to subvert competition.

Why then do the antitrust laws continue to command such powerful support among economists and legal scholars when the pervasive failures are so well known? There are several possible explanations. Antitrust consultants and expert witnesses often stand to make a good deal of money, so financial self-interest may preclude criticism of antitrust. Many economists are also unable to voice informed opinions on antitrust. If it is not their area of expertise, they may not have kept up with research over the past thirty years, or excessive concentration on mathematical models may have left some economists somewhat detached from economic reality. Finally, it is widely believed that there was once a "golden age of antitrust" during which the public was protected from rapacious monopolists by

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benevolent public servants. According to this perspective, although mistakes have been made, more knowledgeable and public-spirited regulators can successfully reform antitrust. Once reformed, antitrust policy can then perform its original purpose and defend competition and free enterprise.

Unfortunately, the Sherman Act was never intended to protect competition. It was a blatantly protectionist act designed to shield smaller and less efficient businesses from their larger competitors. There never was a golden age of antitrust. The standard account of the origins of antitrust is a myth.

As long as the antitrust laws exist, they will be subject to political manipulation. As William Baumol and Janusz Ordover have predicted, "far from serving as a bulwark of competition, these institutions will become the most powerful instrument in the hands of those who wish to subvert it."

The Sherman Act was never intended to protect competition. It was a blatantly protectionist act designed to shield smaller and less efficient businesses from their larger competitors.

Antitrust before the Sherman Act

The real origins of antitrust lie with the state legislatures. A number of states passed antitrust legislation before the Sherman Act. A brief examination of these state initiatives will help to set the stage for the Sherman Act as well as to provide important clues about the goals of nineteenth century antitrust advocates.

Missouri was representative of the midwestern farm states that passed antitrust laws in the late 1880s. At the time, Missouri farmers were concerned about increasing competition from larger, more efficient farms. The Missouri Farmers' Alliance repeatedly warned of the dangers of "the land concentrating in the hands of capitalists." An 1889 meeting of the National Farmers' Alliance in St. Louis issued a declaration that urged "care for the widows and . . . orphans" and then called for legislation "to suppress . . . all unhealthy rivalry."

The farmers were bitter about low and falling agricultural prices, and they blamed the trusts for the perceived decline in their economic position. Historian David D. March observed in his book *History of Missouri*, "Just as the low price of raw cotton spurred the expansion of the Southern Alliance, so low grain prices in the late 1880s caused thousands of farmers in the wheat belt . . . to join the National Farmers' Alliance."

If Missouri antitrust legislation was intended to benefit consumers, as its proponents claimed, then the real price of farm outputs should have been rising (or not falling), the volume of farm outputs should have been falling (or not rising), and the real price of farm inputs should have been rising. Available evidence indicates that none of these conditions was present.

Farm Output. Cattle, hogs, and wheat were Missouri's major agricultural products in the 1880s. Together they accounted for more than 60 percent of the state's agricultural output in 1889.

The per head value of cattle peaked in Missouri in 1884; by 1889 it had fallen by 28.8 percent. This decline in cattle prices—which occured in all the major cattle-producing states—was accompanied by a steady increase in the quantity of cattle during the 1880s. Measured in pounds of live weight, the cattle supply increased about 50 percent in the United States during the 1880s, while the price per hundredweight received by cattlemen fell from an average of $5.59 in 1880 to $3.86 in 1890—a 15 percent price reduction. The increased supply and reduced prices resulted in lower beef prices for consumers. The average price of beef tenderloins fell nearly 38 percent between 1883 and 1889. These data indicate that the cattle and beef markets were becoming increasingly competitive—not being monopolized—during the 1880s.

As with cattle, the market value of hogs in Missouri peaked in the early 1880s. The value of a Missouri-raised hog in 1889 was approximately 19 percent lower than it had been six years earlier. Moreover, the nationwide output of hogs and hog products increased during the 1880s while hog prices fell precipitously—from $6.07 in 1880 to $3.60 in 1890—a decrease of more than 40 percent. Similarly, the trend of Missouri wheat prices was downward during the 1880s, although they fluctuated a great deal. The 1889 price of wheat was about 35 percent lower than it had been a decade earlier.

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In sum, the data regarding output and prices do not support the claim that Missouri agriculture was being monopolized in the late 1880s.

Farm Inputs. Missouri farmers also complained that trusts were monopolizing their inputs, especially railroad transportation. There is widespread agreement among economic historians, however, that although railroad rates did fluctuate, the trend after the Civil War was steadily downward. Stigler has pointed out, "Average railroad freight charges per ton mile had fallen by 1888 to 54 percent of the 1873 level, with all lines in both the eastern and western regions showing similar declines." The quantity of rail services also expanded rapidly during this period. In Missouri there were 4,234 miles of track in 1880; by 1889 there were 6,118 miles, a 45 percent increase. The evidence indicates that the railroad industry was increasingly competitive during the period.

The antimonopoly protests of the agrarians during the 1880s were protests against lower output prices and the increasingly nationwide scope of competition fostered by railroad expansion. Output restriction and higher prices were not in evidence.

Nor is there factual support for the farmers' contention that financing costs increased during the late nineteenth century. Real interest rates fell sharply during the 1880s. In the Midwest real interest rates on farm mortgages fell from an average of 11.41 percent in 1880 to 7.84 percent in 1889, a 31 percent reduction.

Data on nineteenth century farm machinery prices in Missouri are difficult to come by, but economic historian Homer Clevenger has reported that "in terms of bushels of wheat, oats, or corn, a mowing machine, binder, or cultivator could be bought for less in 1892 than in 1882 in Missouri." Economists Marvin Towne and Wayne Rasmussen have constructed an index of U.S. farm machinery prices (in constant 1910 dollars), and they found that farm machinery was two and one-half times more expensive in 1870 than it was in 1890.

One final piece of evidence contradicts the claim that Missouri and other midwestern states were falling into the grips of the monopolistic trusts. In 1870, 20,542 railroad cars were loaded or unloaded in St. Louis. By 1890 this number had increased 16 times to a total of 323,506. Though only suggestive, these figures imply that the Missouri economy was becoming ever more competitive.

It appears that the antimonopoly protests of the agrarians during the 1880s were protests against lower output prices and the increasingly nationwide scope of competition fostered by railroad expansion. Output restriction and higher prices—the universally acknowledged features of monopoly—were not in evidence.

Cattlemen, Butchers, and Meatpackers. The increasingly centralized butchering and meatpacking processes developed in Chicago in the early 1880s played an important role in farmers' agitation for state and federal antitrust laws. The "big four" meatpackers—Swift, Armour, Morris, and Hammond—had vertically integrated into wholesaling and retailing, and they all made extensive use of the new refrigeration technology that enabled them to ship beef across the country from their facilities in Chicago. These developments fostered economies of scale in the meatpacking business that caused the price of meats to consumers to fall throughout the 1880s.

In response there arose talk of a "beef trust" among the cattlemen and local butchers who were having trouble competing with the big four. Cattlemen complained that the big four meatpackers were "conspiring" to depress the price of cattle, and they lobbied for "suitable legislation" to support cattle interests in their "struggle against the dressed-beef industry." Local butchers, meanwhile, also sought an antitrust law that would stop the decline in meat prices to consumers. They succeeded in convincing the U.S. Senate to form a commission to investigate the beef trust. Sen. George Vest of Missouri chaired the commission.

The Vest Commission concluded that "the principal cause of the *depression* in the prices paid to the cattle raiser and of the remarkable fact that the cost of beef to the consumer has not decreased *in proportion*, comes from the artificial and abnormal centralization of markets, and the absolute control by a few operators thereby made possible" (emphasis added). The Vest Commission uncovered no evidence of col-

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lusion, but its members felt that something devious must be going on, and the final report supported anti-beef-trust legislation. Several state-level commissions addressing the same issue reached similar conclusions despite the fact that none of them found evidence of anything but an increasingly competitive industry with declining prices and expanding output.

The Missouri state legislature passed its antitrust law in May 1889. The statute prohibited "restraints of trade" if the effects were "to fix or limit the amount or quantity of any article, commodity, or merchandise to be manufactured, mined, produced, or sold" in Missouri. The statue also prohibited actions intended "to limit or fix the price of outputs."

One possible meaning of the phrase "to limit" is "to keep from rising." This interpretation implies that the Missouri law actually tried to prohibit holding prices down. The facts overwhelmingly support this proproducer, anticonsumer interpretation of the Missouri antitrust law, which was imitated by several other states before the Sherman Act was finally passed in 1890.

Interest Group Politics and the Sherman Act

As in Missouri, widespread economic change produced myriad pleas from relatively small, but politically active, farmers who sought protection from larger, corporate competitors. Historian Sanford Gordon offered an example: "Perhaps the most violent reaction [against industrial combinations] of any single special interest group came from farmers. . . . They singled out the jute bagging and alleged binder twine trust, and sent petitions to both their state legislators and to Congress demanding some relief. Cotton was suggested as a good substitute for jute to cover their cotton bales. In Georgia, Mississippi, and Tennessee the [farmers'] alliances passed resolutions condemning the jute bagging trust and recommended the use of cotton cloth."

Southern farmers were annoyed that consumers increasingly preferred jute to the cotton cloth they produced, and they sought antitrust legislation that would dissolve their competition. Such special-interest behavior was characteristic of the farm lobby. During the 51st Congress, Gordon notes that "64 petitions and memorials were recorded in the *Congressional Record,* all calling for action against combinations. These were almost exclusively from farm groups. . . . The greatest vehemence was expressed by representatives from the Midwest."

Farmers complained to their national representatives that the products they bought from the trusts were increasingly expensive relative to the prices of farm products, but the facts do not support this contention. From 1865 to 1900 farm prices were falling, but at a slower rate than the general price level. This produced real income gains for farmers. In addition, the rapidly increasing quality of manufactured goods further improved farmers' standards of living. The volatility of farm prices caused the farmers to be politically active.

Many other groups joined the antitrust coalition—small business organizations, academicians (though not economists), and journalists. They argued that the "giant monopolies" were creating a "dangerous concentration of wealth" among the capitalists of the day. Although the conspicuous wealth of entrepreneurs such as Rockefeller, Vanderbilt, Mellon, and Morgan added fuel to this charge, it does not appear to be true. In fact, economic historians have concluded that from 1840 to 1900, the division of national income between labor and property owners (capital and natural resource suppliers) remained in a 70 to 30 ratio. Over the same time span, both capital and developed natural resources increased faster than the labor force. This means that labor incomes per unit of labor rose compared with profits and interest per unit of property input.

The conspicuous wealth of entrepreneurs added fuel to the charge that "giant monopolies" were creating a "dangerous concentration of wealth" among capitalists. Many supporters of antitrust legislation found that their own incomes had fallen and urged that the powers of the government improve the situation.

Although there was no significant redistribution of wealth from labor to capital owners in the aggregate, competitive markets always alter the distribution of income in ways that some do not like. There was no "dangerous concentration of wealth," but many supporters of antitrust legislation found that their own incomes had fallen (or not increased rapidly enough). The push for

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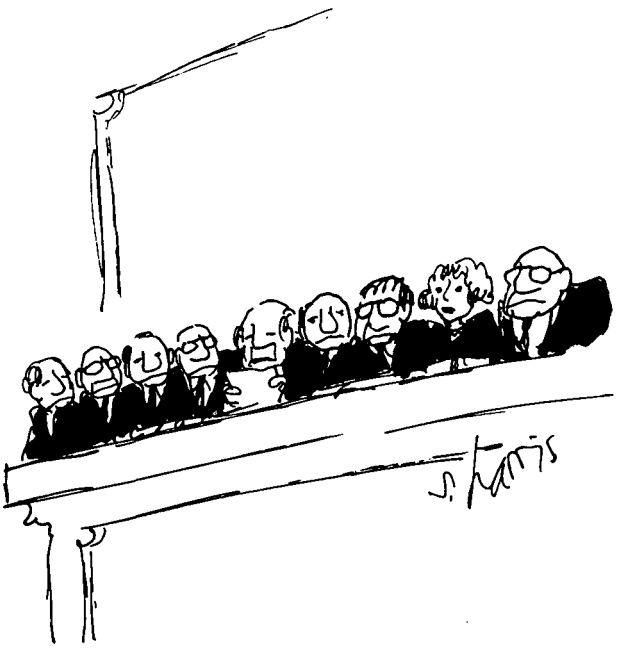
antitrust legislation was an attempt to use the powers of the government to improve the situation.

Economic conditions were changing rapidly in the latter part of the nineteenth century. Expansion of the railroad and inland shipping industries greatly reduced the cost of transportation. Technological developments led to large-scale (and lower-cost) production of steel, cement, and other goods. Communications technology rapidly expanded, especially the use of the telegraph. And the capital markets became more sophisticated. The United States also underwent a rapid transition from a predominantly agrarian to an industrial society. In 1810 the ratio of farm to nonfarm labor was approximately 4.0. This ratio fell to 1.6 by 1840, and by 1880 the labor force was about equally divided between farm and nonfarm endeavors. Meanwhile, individuals and groups uncomfortable with rapid change were becoming increasingly adept at using the regulatory powers of the state. In this increasingly mercantilist atmosphere, the Sherman Act was passed in 1890.



"Keeping in mind Armstead v. California, 1967, and Conway v. Dade County, 1972, the Court finds, by a vote of 7 to 2, that the price of $1.79 for a pound of prunes is unfair and absurd."

Were the Trusts Monopolistic?

In introducing federal "antitrust" legislation, Sen. Sherman and his congressional allies claimed that combinations or trusts tended to restrict output and thus drove up prices. If Sherman's claims were true, then there should be evidence that those industries allegedly being monopolized by the trusts had restricted output. By contrast, if the trust movement was part of the evolutionary process of competitive markets responding to technological change, one would expect an expansion of trade or output. In fact, there is no evidence that trusts in the 1880s were restricting output or artificially increasing prices.

The *Congressional Record* of the 51st Congress provides a list of industries that were supposedly being monopolized by the trusts. Those industries for which data are available are salt, petroleum, zinc, steel, bituminous coal, steel rails, sugar, lead, liquor, twine, iron nuts and washers, jute, castor oil, cotton seed oil, leather, linseed oil, and matches. The available data are incomplete, but in all but two of the seventeen industries, output *increased*—not only from 1880 to 1890, but also to the turn of the century. Matches and castor oil, the only exceptions to the general rule, hardly seem to be items that would cause a national furor, even if they were monopolized.

As a general rule, output in these industries expanded more rapidly than GNP during the ten years preceding the Sherman Act. In the nine industries for which nominal output data are available, output increased on average by 62 percent; nominal GNP increased by 16 percent over the same period. Several of the industries expanded output by more than ten times the increase in nominal GNP. Among the more rapidly expanding industries were cottonseed oil (151 percent), leather goods (133 percent), cordage and twine (166 percent), and jute (57 percent).

The United States underwent a rapid transition from a predominantly agrarian to an industrial society. Individuals and groups uncomfortable with rapid change were becoming increasingly adept at using the regulatory powers of the state. In this atmosphere the Sherman Act was passed.

Real GNP increased by approximately 24 per-

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cent from 1880 to 1890. Meanwhile, the allegedly monopolized industries for which a measure of real output is available grew on average by 175 percent. The more rapidly expanding industries in real terms included steel (258 percent), zinc (156 percent), coal (153 percent), steel rails (142 percent), petroleum (79 percent), and sugar (75 percent).

These trends continued from 1890 to 1900 as output expanded in every industry but one for which we have data. (Castor oil was the exception.) On average, the allegedly monopolized industries continued to expand faster than the rest of the economy. Those industries for which nominal data are available expanded output by 99 percent, while nominal GNP increased by 43 percent. The industries for which we have data increased real output by 76 percent compared with a 46 percent increase in real GNP from 1890 to 1900.

As with measures of output, not all of the relevant price data are available, but the information that is at hand indicates that falling prices accompanied the rapid expansion of output in the "monopolized" industries. In addition, although the consumer price index fell by 7 percent from 1880 to 1890, prices in many of the suspect industries were falling even faster.

The average price of steel rails, for example, fell by 53 percent from $68 per ton in 1880 to $32 per ton in 1890. The price of refined sugar fell from 9 cents per pound in 1880, to 7 cents in 1890, to 4.5 cents in 1900. The price of lead dropped by 12 percent, from $5.04 per pound in 1880 to $4.41 in 1890. The price of zinc declined by 20 percent, from $5.51 to $4.40 per pound from 1880 to 1890.

The sugar and petroleum trusts were among the most widely attacked, but there is evidence that these trusts actually reduced prices from what they otherwise would have been. Congress clearly recognized this. During the House debates over the Sherman Act, Congressman William Mason stated, *"Trusts have made products cheaper, have reduced prices;* but if the price of oil, for instance, were reduced to one cent a barrel, it would not right the wrong done to the people of this country by the 'trusts' which have destroyed legitimate competition and driven honest men from legitimate business enterprises" (emphasis added). Sen. Edwards, who played a key role in the debate, added, "Although for the time being *the sugar trust has perhaps reduced the price of sugar, and the oil trust certainly has reduced the price of oil immensely,* that does not alter the wrong of the principle of any trust" (emphasis added). Perhaps it would be more accurate to describe the Sherman Act as an anti-price-cutting law.

One final argument could be made that the trusts were practicing predatory pricing, that is, that they were pricing below their costs to drive out competitors. But in more than a century of looking for a proven real-world monopoly actually created by predatory pricing, an example has yet to be found. Moreover, prices charged by the nineteenth century trusts continued to fall for more than a decade. What rational businessman would continue to price below cost for more than ten years?

Evidence exists that a major political function of the Sherman Act was to serve as a smoke screen behind which politicians could grant tariff protection to their big business constituents while assuring the public that something was being done about the monopoly problems.

In sum, the nineteenth century trusts were not guilty of the charge levied against them by Sen. Sherman. There is no consistent evidence that they restricted output to raise prices.

Government: The True Source of Monopoly

It appears that one function of the Sherman Act was to divert public attention from a more certain source of monopoly—government. In the late nineteenth century, tariffs were a major source of trade restraints, but the Sherman Act made no provision for attacking tariffs or any other government-created barriers to competitive entry. In fact, evidence exists that a major political function of the Sherman Act was to serve as a smoke screen behind which politicians could grant tariff protection to their big business constituents while assuring the public that something was being done about the monopoly problem.

In a particularly revealing statement during the debates over the antitrust act, Sen. Sherman attacked the trusts on the ground that they "sub-

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verted the tariff system; they undermined the policy of government to protect . . . American industries by levying duties on imported goods." This is certainly an odd statement from the author of the "Magna Carta of free enterprise." But increased output and reduced prices in these increasingly efficient industries apparently dissipated the monopoly profits previously generated by the tariffs. This worked against the objectives of the protected industries and their legislative champions, including Sen. Sherman.

Even more damning is the fact that just three months after the Sherman Act was passed, Sen. Sherman, as chairman of the Senate Finance Committee, sponsored legislation popularly known as the "Campaign Contributors' Tariff Bill" that sharply raised tariff rates. On October 1, 1890, the *New York Times* reported: "The Campaign Contributors' Tariff Bill now goes to the president for his signature, which will speedily be affixed to it, and the favored manufacturers, many of whom . . . proposed and made the [tariff] rates which affect their products, will begin to enjoy the profits of this legislation."

The Sherman Act won legislators votes and campaign contributions from farmers and small businessmen who thought antitrust regulation would protect them from their more efficient competitors, and the tariff bill was supported by all U.S. manufacturers, large and small.

The *New York Times* further reported that "the speech of Mr. Sherman on Monday [September 29, 1890] should not be overlooked, for it was one of confession." Apparently, Sen. Sherman withdrew his speech from the *Congressional Record* for "revision," but a reporter obtained an unabridged copy of the original. The *New York Times* reported: "We direct attention to those passages [of Sherman's speech] relating to combinations of protected manufacturers designed to take full advantage of high tariff duties by exacting from consumers prices fixed by agreement after competition has been suppressed. . . . Mr. Sherman closed his speech with some words of warning and advice to the beneficiaries of the new tariff. He was earnest enough in his manner to indicate that he is not at all confident as to the outcome of the law. The great thing that stood in the way of the success of the bill, he said, was whether or not the manufacturers of this country would permit free competition in the American market. The danger was that the beneficiaries of the bill would combine and cheat the people out of the benefits of the law. They were now given reasonable and ample protection, and if they would resist the temptation attaching to great aggregations of capital to combine and advance prices, they might hope for a season of great prosperity. . . . He did hope, the Senator concluded, that the manufacturers would open the doors to fair competition and give its benefits to the people. . . . He hoped the manufacturers would agree to compete one with another and would refuse to take the high prices that are so easily obtained."

It was absurd, of course, for Sen. Sherman to say that a protective tariff would actually help consumers if only manufacturers could be trusted to refrain from raising prices. The whole purpose of tariff protection is to allow domestic manufacturers to raise prices, or at least to avoid reducing them. Such hypocrisy led the *New York Times* to withdraw its support of antitrust legislation. The *Times* concluded: "That so-called Anti-Trust law was passed to deceive the people and to clear the way for the enactment of this . . . law relating to the tariff. It was projected in order that the party organs might say to the opponents of tariff extortion and protected combinations, 'Behold! We have attacked the Trusts. The Republican party is the enemy of all such rings.' And now the author of it can only 'hope' that the rings will dissolve of their own accord." Thus, the Sherman Act seems to have been passed to help draw public attention away from the process of monopolization through tariff protection.

The Sherman Act won legislators votes and campaign contributions from farmers and small businessmen who thought antitrust regulation would protect them from their more efficient competitors, and the tariff bill was supported by all U.S. manufacturers, both large and small. In a political sense, then, the Sherman Act was very efficient. Congress itself seems to have been one of the principal special-interest groups to benefit from antitrust legislation.

Economists and the Emergence of Antitrust

Although most economists today favor stricter antitrust regulation, from the 1880s until the

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1920s the economics profession expressed nearly unanimous opposition to antitrust. When Sanford Gordon surveyed professional journals in the social sciences and articles and books written by economists before 1890, he found, "A big majority of the economists conceded that the combination movement was to be expected, that high fixed costs made large-scale enterprises economical, that competition under these new circumstances frequently resulted in cutthroat competition, that agreements among producers was a natural consequence, and the stability of prices usually brought more benefit than harm to the society. They seemed to reject the idea that competition was declining, or showed no fear of decline."

George Stigler has also noted economists' initial disapproval of antitrust: "For much too long a time students of the history of antitrust policy have been at least mildly perplexed by the coolness with which American economists greeted the Sherman Act. Was not the nineteenth century the period in which the benevolent effects of competition were most widely extolled? Should not a profession praise a Congress which seeks to legislate its textbook assumptions into practice?" Stigler offered three possible explanations. First, economists did not appreciate the importance of tacit collusion. Second, they had too much confidence in other forms of regulation as a means of dealing with monopoly. Third, they underestimated the income they would receive as antitrust consultants.

These explanations are plausible, but there may be an even more important reason for the transformation of economists' attitudes toward antitrust. In the late nineteenth century most economists viewed competition as a dynamic, rivalrous process, similar to the theory of competition embodied in the work of Adam Smith and today's Austrian economists. Consequently, they tended to regard mergers as a natural consequence of the competitive struggle and not something that should be interfered with by antitrust legislation. Although some industries were becoming more concentrated in the late nineteenth century, rivalry was still as strong as ever, as the rapid expansion of output and the decline in prices attest. Thus, the economists of the time saw no reason to interfere with market processes through antitrust regulation.

Beginning in the 1920s, mathematical economists developed the so-called perfect competition model, and it replaced the older theory. To economists competition no longer meant rivalry and enterprise. Instead, it meant the equation of price and marginal cost. Most important, it meant that there must be "many" firms in "unconcentrated" industries. Once economists began to define competition in terms of market structure, they became more and more enamored with antitrust regulation as a way of forcing the business world to conform to their admittedly unrealistic theory of competition.

Economist Paul McNulty has noted: "The two concepts [of competition] are not only different;

The perfect competition model and its corollary, the structure-conduct-performance paradigm of industrial organization theory, have seriously misled the economics profession, at least as far as antitrust policy is concerned.

they are fundamentally incompatible. Competition came to mean, with the mathematical economists, a hypothetically realized situation in which business rivalry . . . was ruled out by definition." Friedrich Hayek has made an even stronger statement: "What the theory of perfect competition discusses has little claim to be called 'competition' at all and . . . its conclusions are of little use as guides to policy." Moreover, wrote Hayek, "If the state of affairs assumed by the theory of perfect competition ever existed, it would not only deprive of their scope all the activities which the verb 'to compete' describes but would make them virtually impossible." Advertising, product differentiation, and price undercutting, for example, are all excluded by definition from a state of "perfect" competition which, according to Hayek, "means indeed the absence of all competitive activities."

Those economists who use market structure to measure competition are likely to have a favorable attitude toward antitrust regulation. Stigler asserted more than thirty years ago, "One of the assumptions of perfect competition is the existence of a Sherman Act." To the nineteenth century economists, however, an antitrust law was incompatible with rivalry and free enterprise. The perfect competition model and its corollary, the structure-conduct-performance para-

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digm of industrial organization theory, have seriously misled the economics profession, at least as far as antitrust policy is concerned.

The Importance of the Origins of Antitrust

The whole philosophical or ideological defense of government regulation is based on the notion that free markets are prone to various "imperfections" such as so-called "free-market monopoly." Government regulation supposedly escalated in the late nineteenth and early twentieth centuries as a benevolent and public-spirited response to growing market "failures." But research in public choice economics, the economics of property rights, and the "new economic history" is beginning to cast serious doubt on this standard account of the origins of government regulation.

Just as in other areas, the history of the origins of antitrust has indeed been distorted. The economy in the 1880s was increasingly competitive. Output in the allegedly monopolized industries was expanding rapidly, and prices were falling. Antitrust was government's response to politically powerful farmers and small businessmen who were opposed to economic change and sought protectionist legislation. Even members of Congress admitted that the trusts had caused lower prices. There is little evidence, therefore, that the "legislative intent" of the Sherman Act was to protect consumers. Evidence indicates the intent was to protect politically powerful producer groups at the expense of consumers.

This fact underscores another reason to explore the origins of antitrust. Robert Bork's legal philosophy, which is shared by many other legal scholars and practitioners, is that the courts should not be "activists" in creating new "rights" or laws with their decisions. Instead, argues Bork, the courts should defer to the legislature and seek to issue rulings in accord with legislative wishes.

If the Sherman Act was protectionist legislation, and if the courts adhere to the Bork philosophy, then the subversion of competition through antitrust legislation is perfectly acceptable, even desirable. By contrast, a legal philosophy that emphasizes government's role in protecting private property and individual liberties would urge the courts to strike down such legislation as unconstitutional. Antitrust is, above all else, an abrogation of freedom of contract. Thus, George Stigler was wrong when he asserted that the Sherman Act is a "public-interest law" just like the enforcement of contracts.

There are enormous, unmeasurable social costs involved in antitrust. Alan Greenspan once described the environment created by antitrust as being "reminiscent of Alice's Wonderland: everything seemingly is, yet apparently isn't simultaneous. It is a world in which competition is lauded as the basic axiom and guiding principle, yet 'too much' competition is condemned as 'cutthroat.' It is a world in which actions designed to limit competition are branded as criminal when taken by businessmen, yet praised as 'enlightened' when initiated by the government. It is a world in which the law is so vague that businessmen have no way of knowing whether specific actions will be declared illegal until they hear the judge's verdict—after the fact." Uncertain about what is truly competitive and legal, businesses tend to avoid efficiency-enhancing moves. As the history of antitrust shows, however, such vagueness is ideal for political demagogues who can enact economically harmful but politically profitable policies, such as protectionism, and then use the antitrust laws as a platform for blaming the private sector for the economic problems the political system has created.

A legal philosophy that emphasizes government's role in protecting private property and individual liberties would urge the courts to strike down the Sherman Act as unconstitutional.

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Innovation, Dynamic Competition, and Antitrust Policy

Thomas M. Jorde and David J. Teece

The centennial of the Sherman Act affords us the opportunity to assess the relevance of antitrust law for the global economic environment of the future. Antitrust law has undergone significant changes since the passage of the Sherman Act in 1890, but the U.S. and world economies have undergone far greater changes. Although we do not advocate its abolition, we suggest that antitrust may be anachronistic in certain contexts, and, indeed, may inhibit effective competition. Specifically, we suggest that if society wishes to promote competition, the best way to do so is to promote innovation. That may require dismantling portions of our antitrust laws, which are largely based on neoclassical microeconomic analysis that aspires to a kind of competition—perfect competition—that may not really matter if enhancing long-run economic welfare is the goal of antitrust. Rather, it is dynamic competition that really counts.

Dynamic competition is the competition that comes from the development of a new product or process. There are at least two types of innovative regimes that stimulate rivalry—incremental innovation and radical innovation. With incremental innovation new products are introduced in rapid succession, the new product drives out the old one, and established firms will fall into decline if they do not keep up with changing technology. Such is the case with the aircraft, chemical, and VCR industries. Radical innovation requires a clean break with the past. Few industries are characterized by radical innovation for long periods of time. Yet the invention of the transistor did more to invigorate competition and to provide economic benefits than did any rivalry among manufacturers of vacuum tubes.

Recognizing these forms of dynamic competition would not cause any tension with existing antitrust laws if the world of competition envisaged in the textbook and so often reflected in the antitrust law was the ideal structure from which innovation and its successful commercialization would emerge. There is, however, no evidence that perfect competition is, in fact, ideal for promoting innovation. The weight of the evidence appears to suggest that the structure of markets—whether competitive or monopolistic—has little effect on innovation. The evidence does suggest that current monopoly is usually transitory, that most truly radical innovations emerge from outside an established industry, and that access to the infrastructure provided by

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existing firms is usually not critical to ultimate success. In addition, market structure has little effect on incremental innovation.

What, then, does innovation require? Although the evidence is sketchy, factors that are important include: the availability of a labor force with the requisite technical skills; economic structures that permit considerable autonomy and entrepreneurship; economic systems that permit and encourage a variety of approaches to technological and market opportunities; access to "venture" capital, either from a firm's existing cash flow or from an external venture capital community; good connections between the scientific community, especially the universities, and the technological community, and between users and developers of technology; strong protection of intellectual property; the availability of strategies and structures to enable innovating firms to capture a return from their investment; and, in fragmented industries, the ability to quickly build or access cospecialized assets inside or outside the industry.

Antitrust policy does little to enshrine these factors. Moreover, antitrust negatively affects the ability of innovating firms to cooperate in developing and commercializing innovations or to engage in business strategies or interfirm agreements to keep "me too"-type imitators at bay.

The implicit acceptance in current antitrust law of the textbook model of perfect competition—which is inherently short-run—may be counterproductive in the long run. There is no good theoretical reason nor any evidence to believe that present antitrust policy advances dynamic competition and economic growth.

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Innovation and its rapid and profitable commercialization and diffusion are the key factors driving productivity improvement in the economy. Accordingly, the focus of antitrust on short-run consumer welfare is possibly misplaced. Consumer welfare is enhanced in the long run only if productivity increases, and that requires technological innovation. If consumer welfare is to be the goal of antitrust, it needs to be couched in a forward-looking, innovation-centered context. Otherwise, antitrust policy may unwittingly diminish a nation's economic welfare.

We believe that adopting dynamic competition and innovation as the goal of antitrust would serve consumer welfare over time more assuredly than does the current focus on short-run consumer welfare. To stimulate dynamic competition and innovation, U.S. antitrust policy must reconsider how it assesses market power and how it treats cooperative agreements among competitors.

Assessing Market Power

There is no area where antitrust policy and practice display so clearly their adherence to textbook notions of perfect competition than in defining markets and assessing market power. Market definition, normally the first step in assessing market power, is a critical element of antitrust theory and enforcement policy. As a general rule, in the absence of significant market power, every form of business behavior other than price-fixing and its economic equivalents is legal. Prove market power, however, and the reasonableness of all business practices will be closely scrutinized. Market power is often proved if "dominance" exists, if prices are above full costs, or if profits are above "competitive levels."

Using accepted methodologies for establishing markets such as the Justice Department's test described in the *Merger Guidelines*, one can easily but incorrectly assign market power to an innovating firm. Although the monopoly power associated with innovation is often quite transitory, standard entry barrier analysis—with its one- to two-year time fuse for entry—will often not undo a finding of monopoly power for an innovator. Accordingly, innovators may need to constrain their business conduct severely to avoid violating the antitrust laws. In today's global economy with low or nonexistent tariffs, however, one of the few ways one can attain

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market dominance in the United States is through an innovative success.

We should not be concerned if innovating firms gain market dominance. If their technological contribution is significant, we should applaud the firm's ability to commercialize its technology successfully. Properly interpreted, the antitrust laws do not condemn the possession of monopoly power that results from a superior product, good business acumen, or technological innovation. Possession of market power (or dominance) will, however, trigger careful scrutiny of business conduct under Sherman Act rule-of-reason analysis. Firms must be careful not to prevent others from competing on the merits. And while defenses are available to firms with market power to demonstrate that their conduct is efficient and procompetitive, ultimately the question of "reasonableness" is decided by a jury of lay persons. As a practical matter that means that firms with market power face some uncertainty about how their conduct will be evaluated. The costs of this uncertainty are heightened in the United States because treble damages are available to private antitrust litigants. Ultimately, such uncertainty dampens the incentives to innovate and market new technologies.

There are a number of ways to adjust market definition and market power assessment to measure correctly the competitive impact of new products and processes. One would be to lengthen the entry time in weighing the existence of substitutes. For example, to analyze entry barriers in the semiconductor industry, which is characterized by rapid technological change, we could use a different time dimension than we would for the automobile industry, where innovation is less significant. A second approach would involve using higher market concentration thresholds for establishing market power. A third approach would be to abandon the implicit and sometimes explicit use of price elasticity of demand as the dominant criterion for deciding upon the presence or absence of close product substitutes. As an alternative, one would look at the responsiveness of the demand for a product to variations in its performance, not to variations in its price.

The reason for emphasizing performance is that in the early stage of the product life cycle, competition typically proceeds on the basis of product performance, not price. For example, in the early days of the automobile industry, steam cars competed with internal combustion-powered cars. Thus, if changing a product or process with respect to one or more key attributes would affect the consumption of products outside of a provisional product market, then differentiated products, even if based on alternative technologies, should be included in the relevant product market. Of course, product changes that depend on technology not currently developed should be excluded.

A firm may exercise market power for a significant period of time only if barriers to entry exist. Thus, the analysis of entry conditions is of great importance to defining markets and assessing market power. If entry is easy, then not even a concentrated market will provide established firms with market power.

In its *Merger Guidelines*, the Department of Justice considers the likelihood and probable magnitude of entry in response to a small but significant and nontransitory increase in price over a period of two years. Yet orthodox approaches, including the merger guidelines, do not devote a great deal of attention to measuring entry barriers, despite their recognized importance. The guidelines do not provide criteria for discriminating among entry barriers that are high as opposed to those that are low. In short, received theory provides little guidance as to how one should measure and assess potential competition.

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It is especially in assessing potential competition that a departure must be made from orthodox approaches when new technologies and new products are at issue. The reason is that potential competition from new technologies can destroy a firm's position in a particular market and

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its underlying competences. Price competition, on the other hand, may erode profit margins but is less likely to completely destroy the value of a firm's underlying technological, physical, and human assets. Accordingly, potential competition from new products and processes is the more powerful form of competition.

Hence, potential competition from new products and processes is most likely to spur an established firm to action. In most instances potential competition can be more important than actual competition in industries experiencing or expected to experience rapid technological change. We recognize, however, that in some emerging industries, assessing the extent of potential competition may be difficult. But even in nascent industries we believe that potential competition, and hence entry barriers, can be assessed through a detailed analysis of entry requirements and the market for know-how. The important point to recognize is that new product introductions are simply the result of R&D activities, so that the speculative dimension to assessing potential competition can be eliminated

In most instances potential competition is a more important competitive consideration than actual competition in industries experiencing or expecting to experience rapid technological change. While in some emerging industries assessing the extent of potential competition may be difficult, it can be assessed through an analysis of entry requirements and the market for know-how.

or greatly reduced by looking upstream in the new product development process. While this involves assessing research activity that is often proprietary, it is sometimes surprising how much information is commonly available on new product and process development activities.

New technologies sometimes stem from public research, such as that sponsored in universities and government laboratories. Such was the case in solid-state electronics two decades ago; such is the case in biotechnology and computer software today. In other industries, such as jet engines for civilian and military aircraft, innovations tend to be based upon proprietary knowledge.

In the case of technologies that build upon a public knowledge base, barriers to entry into R&D are usually low, and the proliferation of start-up companies is often the result. Where the knowledge base is more proprietary, higher barriers to entry are likely to exist. Still, to the extent that an active venture-capital market coupled with low barriers to the mobility of scientific and technical manpower is in evidence, barriers into R&D are still likely to be remarkably low.

As we noted earlier, an emerging technology often requires a wide array of capacities in addition to technology to effectuate commercialization. Sometimes these capacities are in manufacturing, sometimes they are in marketing, and sometimes they are in distribution. Other firms may possess complementary technologies, as when a computer hardware innovation requires the support of new software. If innovating firms lack these capabilities in-house, they may be able to access them through collaborative arrangements of one kind or another. If there is a tradition of such activity in an industry or technological area, then it speaks to the facility with which firms with new technologies can quickly become a new and significant competitive force. Hence, in assessing potential competition and barriers to entry, the ability and proclivity of potential competitors to access complementary assets on competitive terms become important factors.

Thus, assessing product market competition in industries experiencing rapid technological change is incomplete unless it explores new products already in the pipeline and those that can easily be put into the new product development pipeline. This leads one to explore markets for know-how in a fashion similar to that which is necessary for the antitrust assessment of R&D joint ventures.

Cooperative Agreements among Competitors

The second area in which traditional antitrust policy may impede innovation is in analyzing cooperative agreements among competitors. The problem arises because the naive view of innovation embedded in current antitrust economics

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and jurisprudence fails to recognize that innovating firms may wish to cooperate to promote innovation.

While innovation is traditionally considered to occur in stages that proceed sequentially from research to development, design, production, and then finally to marketing, sales, and service, a more appropriate view of the process would be one that recognizes the existence of tight linkages and feedback mechanisms that must operate quickly and efficiently, including links between firms, within firms, and sometimes between firms and other organizations such as universities. From this more "simultaneous" perspective, innovation does not necessarily begin with research; nor is the process serial. But it does require rapid feedback, midcourse corrections to designs, and redesign. R&D personnel must be closely connected to manufacturing and marketing personnel and to external sources of supply of new components and complementary technologies so that supplier, manufacturer, and customer reactions can be fed back into the design process rapidly. New technology, whether internal or external, must become embedded into designs that meet customer needs quickly and efficiently. Simultaneous innovation is an incremental and cumulative activity that involves building on what went before, whether it is inside or outside the organization and whether the knowledge is proprietary or in the public domain. IBM followed this model in developing its first personal computer by building alliances with Microsoft and others to launch a successful system. Sun Microsystems and NeXT Computer launched themselves in this way and have remained in this mode for subsequent new product development.

Thus, for innovations to be commercialized, the economic system must somehow assemble all the relevant complementary assets and create a dynamically efficient interactive system of learning and information exchange. The necessary complementary assets can conceivably be assembled by administrative processes, or by market processes, as when the innovator simply licenses the technology to firms that already own the relevant assets or are willing to create them. These organizational choices have received scant attention in the context of innovation. In particular, there has been little consideration of how complex contractual arrangements among firms can assist commercialization by translating R&D capability into profitable new products and processes.

If innovation takes place in a regime in which the technological leader can secure legal protection (as when it obtains an ironclad patent) and if technology can be transferred at zero cost (as is commonly assumed in textbooks), then the organizational challenge that is created by innovation is relatively simple. But in reality, simple unilateral contracts—where technology is sold for cash—are unlikely to be efficient very often.

Traditional antitrust policy may impede innovation in analyzing cooperative agreements among competitors. The problem arises because the naive view of innovation embedded in current antitrust economics and jurisprudence fails to recognize that innovating firms may wish to cooperate to promote innovation.

Because innovation often requires firms to create complex contracts and relationships with other firms to bring technology to the market and to hold "me too"-type imitators at bay, we should consider organizational alternatives available to the innovator to generate, coordinate, and control complementary assets. These include the price mechanism, internal organization, and strategic alliances.

Economic theory generally assumes that the requisite coordination and control can be achieved by the invisible hand. Efficient levels of investment in complementary assets are brought forward at the right time and place by price signals. Entrepreneurship is automatic and costless. This textbook view seems implicit in U.S. antitrust economics. But market failures are likely to arise because of firms' ignorance of their competitors' future actions, preferences, and states of technological information. This uncertainty is especially high for the development and commercialization of new technology. Accordingly, innovating firms need to achieve greater coordination than the price system alone appears to be able to effect.

A second mechanism for effecting coordination uses the administrative processes within the

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"Given the downward slope of our demand curve and the ease with which other firms can enter the industry, we can strengthen our profit position only by equating marginal cost and marginal revenue. Order more jelly beans."

firm. A company's internal organization can serve to shore up some market imperfections and provide some of the necessary coordination. But large integrated structures may become excessively hierarchical and less responsive to market needs. Accordingly, at least for some aspects of innovative activity, smaller organizations are often superior. Unfortunately, antitrust law appears to favor mergers over interfirm agreements and thus burdens innovation by attaching disincentives to otherwise appropriate organization forms.

Strategic alliances, including consortia and joint ventures, are often an effective and efficient way to organize for innovation, particularly when an industry is fragmented. Interfirm cooperation preserves market selection and responsiveness. In a sense, interfirm cooperation is the pure private enterprise solution.

Lying between pure market and full administrative solutions are various forms of agreements between or among firms. An especially interesting one is the strategic alliance characterized by the commitment of two or more partner firms to a common goal. A strategic alliance might include technology swaps, joint R&D or codevelopment, and the sharing of complementary assets, such as where one party manufactures and the other distributes a codeveloped product. Of course, if the common goals were simply price-fixing or market-sharing, then such an agreement would constitute a cartel, especially if the agreement included substantially all members of an industry.

By definition strategic alliances can never have one side receiving cash alone, nor do they include mergers, because alliances by definition cannot involve the acquisition of another firm's assets or the controlling interest in another firm's stock. Alliances need not involve equity swaps or equity investments, although they often do. Strategic alliances without equity typically consist of contracts between or among partner firms that are not affiliated. Equity alliances can take many forms, including minority equity holdings, consortia, and joint ventures. Such interfirm agreements are usually temporary and are assembled and disassembled as circumstances warrant. Typically, only a limited range of the firm's activities are enveloped in such agreements, and many competitors are excluded.

Strategic alliances, including consortia and joint ventures, are often an effective and efficient way to organize for innovation, particularly when an industry is fragmented. Whereas full-blown national planning entails abolishing the market as an organizing mechanism, and large hierarchies are exposed to bureaucratic limits, interfirm cooperation preserves market selection and responsiveness. In a sense, interfirm cooperation is the pure private enterprise solution.

Antitrust Treatment of Agreements among Competitors

The U.S. antitrust treatment of agreements among U.S. competitors puts the United States at a competitive disadvantage compared with Japan and the European Community. Current

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U.S. antitrust law inhibits agreements among competitors to develop and commercialize new technology because the legal standards for interfirm agreements are ambiguous. Although it is generally true that "rule-of-reason" analysis—rather than per se rules—are applied to contractual arrangements designed to advance innovation, the elements of rule-of-reason analysis are muddled. In addition, although current law, as a practical matter, recognizes a "safe harbor" for mergers between firms that will have less than a 20 percent market share, it does not recognize a similar safe harbor for horizontal contractual arrangements among firms.

The Clayton Act also permits private parties to sue for treble damages for alleged antitrust injuries and allows state attorneys general to recover treble damages on behalf of persons residing in the state. Successful plaintiffs can also recover attorneys' fees. These remedies are available only in the United States. They provide a powerful incentive for plaintiffs to litigate, and given the current state of the law, a powerful disincentive for businesses to form cooperative innovation arrangements and strategic alliances. While it is difficult to measure the missed opportunities for cooperative innovation caused by the threat of treble damage litigation, we believe that they are substantial. Moreover, treble damage litigation works to the particular detriment of small and medium-sized innovative firms in industries where the innovative process is simultaneous.

Congress has recognized that these provisions may inhibit technological innovation, and the National Cooperative Research Act of 1984 took two significant steps to remove legal disincentives to cooperative research. First, the act provides that "joint research and development ventures" must not be held illegal per se, and that such ventures instead should be "judged on the basis of [their] reasonableness, taking into account all relevant factors affecting competition, including, but not limited to, effects on competition in properly defined, relevant research and development markets." Second, the act establishes a registration procedure for joint R&D ventures, limiting antitrust recoveries against registered ventures to single damages, interest, and costs, including attorneys' fees. Thus, Congress eliminated the threat of treble damages for litigation challenging cooperative R&D arrangements, provided that the parties to the arrangement first register their venture. But R&D is only a small piece of the innovation puzzle.

In our view the National Cooperative Research Act is not sufficiently permissive. The substantive protection provided by the act—guaranteed rule-of-reason treatment and reduction of damages—extends only to research and downstream commercial activity "reasonably required" for research and is narrowly confined to marketing intellectual property developed through a joint R&D program. The treatment of other agreements designed to facilitate innovation is thus left uncertain, to be determined only by interpretation of the "reasonably required" standard. The act unwisely precludes joint manufacturing and production of innovative products and processes, which are often necessary to provide the cooperating ventures with significant feedback to aid in further innovation and product development and to make the joint activity profitable. The act implicitly rejects simultaneous innovation.

The National Cooperative Research Act is not sufficiently permissive. The substantive protection it provides extends only to research and downstream commercial activity "reasonably required" for research and narrowly confined to marketing intellectual property developed through a joint R&D program.

In addition, the National Cooperative Research Act gives little guidance concerning the substantive content of its rule-of-reason approach. While the act did require that markets be defined in the context of research and not the products that might result from it, the act fails to specify factors to be considered within rule-of-reason analysis. It simply requires consideration of "all relevant factors affecting competition" and pays no particular attention to the special characteristics of the innovation process in a quickly changing industry.

Finally, while eliminating treble damages for registered ventures is an important positive step, the act still does not protect cooperating

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firms from antitrust litigation. Even after the act, antitrust law continues to permit private plaintiffs to engage in treble damage litigation against cooperative arrangements facilitating commercialization. Moreover, single damages are still available even against those registered under the act. The cost of defending antitrust suits is not materially reduced by the exceedingly narrow circumstances in which the act permits an award of attorneys' fees to prevailing defendants. Moreover, the threat of litigation, with attendant managerial distraction, can be extremely damaging to the competitive performance in a fast-paced industry.

In contrast to U.S. antitrust law, the antitrust and business environments in Japan and the European Community are more hospitable to strategic alliances and cooperative arrangements for innovation. Japan believes that joint R&D activities are procompetitive and should not be touched by the Antimonopoly Act.

Businesses seem to have recognized the limited nature of the steps taken by the National Cooperative Research Act. Not surprisingly, only 111 separate cooperative ventures registered under the act between 1984 and June 1988. Our review of these filings indicates that they are very modest endeavors that are aimed at solving industry problems and are not of great competitive moment. We believe that if an approval procedure existed under which procompetitive arrangements could obtain exemptions from further antitrust exposure to private damage actions, then many more competitively beneficial ventures would register under the act.

In contrast to this picture of U.S. antitrust law, the antitrust and business environments in Japan and Europe are more hospitable to strategic alliances and cooperative arrangements for innovation.

Japan. The basic Japanese attitude is that joint R&D activities are procompetitive and thus should not be touched by the Antimonopoly Act. Significantly, the literal Japanese translation of "R&D"—*kenkyu kaihatsu*—implicitly includes commercialization; there is no semantic distinction between the concepts of R&D and commercialization.

In Japan the Fair Trade Commission is responsible for executing and enforcing the Antimonopoly Act of 1947, which (as does the Sherman Act) broadly prohibits unreasonable restraints of trade. While there is no specific legislative exemption for joint innovation arrangements under the act, Japan's Fair Trade Commission has been able to exempt cooperative innovation efforts from the scope of the law by virtue of its power as the primary enforcer of the act. The commission's policy also states that if anticompetitive effects are alleged, the procompetitive benefits of innovation must be weighed in the balance too. Balancing will take place not only within a particular market but also across markets, because "there is a possibility of the emergence of competition at the intersection of industrial sectors as a result of joint R&D between firms in different sectors."

In considering anticompetitive effects of cooperative innovation arrangements, Japan's Fair Trade Commission analyzes market shares and market structure. The commission specifically recognizes the needs of innovators and articulates procompetitive justifications that include the difficulty of single-firm innovation, the faster innovation created by cooperation and specialization between joint participants, the pursuit of innovation in new fields by utilizing shared technology and know-how, and the enhancement of the technological level of each participant through the interchange of technology.

When the Ministry of International Trade and Industry seeks to promote cooperative R&D activities, the commission is consulted in advance. Once the activities are cleared by the commission, it is extraordinarily unlikely that it would pursue antitrust remedies at a future time. Significantly, treble damages are not available to private parties seeking to enforce Japanese antitrust laws, and private suits for single damages are very rare and usually unsuccessful. Thus, Japanese firms cooperating on innovation and commercialization of innovation have little to fear from the Japanese antitrust laws.

In this type of antitrust environment, it is not surprising that there is frequent collaboration for innovation. Although the relevant statistics are not kept in Japan, because there is no reporting requirement for collaborative research and

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commercialization activities, a Fair Trade Commission report issued in 1984 suggests the quantity and variety of joint innovation activities in Japan. The survey results indicate that joint R&D projects among corporations in the same industrial sector, which might be classified as horizontal collaboration, may represent about 19 percent of total projects.

European Community. The antitrust environment shaping cooperation in the European Community is also markedly different from that in the United States. In 1968 the European Commission issued a "Notice of Cooperation between Enterprises" that indicates that horizontal collaboration for purposes of R&D is normally outside the scope of antitrust concerns as defined in Articles 85 and 86 of the EEC Treaty. The commission has consistently taken a favorable position on R&D agreements unless the large entities involved imply serious anticompetitive consequences.

In 1984 the European Commission adopted a regulation expanding the favorable antitrust treatment of R&D. For firms whose total market share does not exceed 20 percent, it provides blanket exemptions for horizontal R&D arrangements, including commercialization—which the commission views as "the natural consequence of joint R&D"—up to the point of distribution and sales. In addition, the commission is authorized to grant exemptions for cooperative efforts that do not fall within the automatic safe harbor.

Proposed Modifications to U.S. Antitrust Law Affecting Cooperative Agreements among Competitors

To ensure that antitrust law is responsive to the needs of innovating firms and does not inhibit U.S. firms from competing effectively in global markets experiencing rapid technological change, we believe that seven changes should be considered. First, market definition should be tailored to the context of innovation and should include attention to the market for know-how. Specific product markets become relevant only when commercialization is included within the scope of the cooperative agreement. Second, the rule of reason should be clarified to take specific account of the appropriability of the technology, the pace of technological change, the diversity of sources of new technology, the need to access complementary assets and technologies, and the need to have close cooperation to manage an innovation process that requires engaging in complex forms of interfirm cooperation. Third, a safe harbor defined according to market power should be expressly adopted that would shield from antitrust liability all interfirm agreements among competitors that involve less than 20 to 25 percent of the relevant market. Fourth, antitrust law should not bias the selection of interfirm organizational forms; at a minimum, integration by contract or alliance should be treated no less favorably than full mergers. Fifth, the National Cooperative Research Act should be amended to include joint production and commercialization efforts to exploit innovation. Sixth, an administrative procedure should be created, involving both the Justice and Commerce Departments, to allow evaluation and possible certification of cooperative arrangements among firms with market shares higher than 20 to 25 percent when dynamic efficiency gains are likely and rivalry is robust. Finally, private antitrust suits challenging cooperative innovation arrangements should be limited to equitable relief, and attorneys' fees should be awarded to the prevailing party.

In the European Community horizontal collaboration for purposes of R&D is normally outside the scope of antitrust concerns. The European Commission has consistently taken a favorable position on R&D agreements unless the large entities involved imply serious anticompetitive consequences.

The first four of these proposals could be accomplished by courts' reinterpreting the antitrust laws. We hope courts will not hesitate to employ the tools of evolutionary common law interpretation and development to achieve these changes. To achieve the complete package of substantive and procedural changes most quickly, however, and thus to assure certainty and predictability, legislation is the best overall solution. We favor providing the opportunity for firms either to register and receive relief from treble damages under an amended National Cooperative Research Act or to apply for a certifi-

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cate of exemption from the Justice and Commerce Departments that would provide even more protection. In exchange for this, however, there would be greater disclosure and scrutiny of business plans. The firms themselves would choose which path to take. Currently, there are resolutions in the House of Representatives that have advanced "registration" or "certification" approaches to cooperative commercialization efforts. We support both types of approaches.

Present U.S. laws do not give full recognition to the interorganizational requirements of the innovation process; failure to do so is damaging when innovation requires simultaneous linkages and feedback mechanisms. As long as industries remain open and innovative, antitrust policy should err on the side of permitting rather than restricting interfirm contracts.

Conclusion

The case for changing the way antitrust law analyzes and assesses market power and agreements among competitors rests on three fundamental pillars. The first is that the innovation process is extremely important to economic growth and development, because it yields social returns in excess of private returns and because innovation is a powerful spur to competition. Hence, if antitrust policy is going to err, it ought to do so by being on the facilitating rather than on the inhibiting side of innovation. This principle is well understood in Europe and Japan. Second, economic theory tells us that if certain organizational arrangements are exposed to governmentally imposed costs while others are not, firms will avoid the burdened forms—interfirm agreements—and adopt the unburdened forms—hierarchy—even when the former are economically superior. According to a leading Japanese scholar, the slowdown in total productivity in the United States can be attributed in large part to a mismatch between organizational form and the requirements of new technology; in particular, he is concerned that hierarchical solutions are overused, at least in the United States. Present laws do not give full recognition to the interorganizational requirements of the innovation process; failure to do so is damaging when innovation requires simultaneous linkages and feedback mechanisms. Third, cartelization of industries experiencing rapid technological change and open to international trade and investment is very difficult. As long as these industries remain open and innovative, antitrust policy should err on the side of permitting rather than restricting interfirm contracts.

There are several classes of circumstances where beneficial cooperation will eventually expand if antitrust laws are revised along the lines we propose. The response may not be immediate, particularly with respect to consortia, because U.S. industry has little experience in this area. Our antitrust history has discouraged consortia, and U.S. firms, at least in the postwar period, have been large relative to their foreign competitors. Accordingly, the need to cooperate has not been so powerful in the past as it is now. Once organizational learning accumulates, however, we expect new organizational arrangements to begin to flourish. We also expect the reinforcement of cooperative alliances already common in U.S. industry.

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Turning Back the Antitrust Clock

Nonprice Predation in Theory and Practice

Donald J. Boudreaux

Arguments that firms can acquire monopoly power by engaging in predatory pricing—that is, by pricing below cost to run rivals out of the industry—have been popular since at least the 1880s. A familiar explanation for the success and dominance of firms such as Standard Oil and the "big four" Chicago meatpackers was that such firms competed overly aggressively. These firms allegedly became monopolists by charging predatory prices—prices their rivals could not match. Although it was recognized that lower prices led to temporary consumer benefits, it was also argued that excessive price-cutting created entrenched monopolies that harmed consumers over the long run.

For almost a century, legislators, jurists, and economists accepted as an article of faith that predatory pricing was a serious problem requiring the attention of some extramarket police such as the courts. But by the 1970s the accumulation of theoretical and empirical analysis challenging the veracity of the predatory pricing doctrine caused its support to unravel. The pricing practices of Standard Oil, the Chicago meatpackers, and many other firms accused through the years of predatory pricing are now recognized as forms of healthy and vigorous competition that increased consumer welfare.

This recognition was reflected in the Supreme Court's 1986 *Matsushita* decision in which the Court rejected the claims of American electronics manufacturers that Matsushita had engaged in predatory pricing. The Court correctly noted, "Cutting prices in order to increase business often is the very essence of competition. Thus, mistaken inferences in cases such as this one are especially costly, because they chill the very conduct the antitrust laws are designed to protect."

Though predatory pricing theory is in a coma (it is not dead), it is being revived by new models of "nonprice" predation. The past two decades have witnessed economists' and lawyers' building elaborate models designed to show how firms might manipulate some variable other than price, such as advertising intensity or product quality, to prey on their rivals and thus acquire monopoly power. Nor is it only academics who fret about the nonprice activities of firms. In November 1989 FTC Chairman Janet Steiger worried aloud to the 23rd New England Antitrust Conference about the anticompetitive consequences of nonprice predation. She also hinted strongly that challenging nonprice predation will be a top priority for her agency.

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A careful critique of the new nonprice predation theories, as well as of the "raising-rivals'-costs" literature, reveals, however, that they are no more valid than the widely discarded predatory pricing stories.

Nonprice Predation

The fatal flaw in traditional predatory pricing theory is that such a strategy always requires the predator to incur larger losses than its rivals during the price war. This makes it impossible to explain why the predator expects to hurt its rivals more than it hurts itself. Rather than being deterred by predatory pricing, rival firms should welcome such behavior. Of course, scholars who believe that predatory pricing occurs made various attempts to explain away this thorny problem—arguing, for example, that if the predator had access to less costly capital than did its rivals, the predator could successfully fund a price war. But no such explanations have proved persuasive.

Nonprice predation theories initially seem to avoid this flaw. When a firm engages in nonprice predation, it need not always incur larger costs than it imposes on its rivals. For example, in a recent law review article advocating government policing of nonprice predation, Rep. Thomas Campbell, formerly a law professor at Stanford University, claimed: "Changing a product characteristic affects the rest of the market far less than across-the-board predatory price-cutting in a market of homogeneous goods. An existing firm suffers far fewer losses than its equally efficient victim, making such conduct feasible. This activity imposes social costs and makes deterrence [of rivals] credible."

The fatal flaw in traditional predatory pricing theory is that such a strategy always requires the predator to incur larger losses than its rivals during the price war. This makes it impossible to explain why the predator expects to hurt its rivals more than it hurts itself.

To illustrate his argument that nonprice predation is a rational business strategy, Rep. Campbell offered a hypothetical example. Suppose that Sugar Smacks, Life, and Corn Flakes are the only breakfast cereals in the market, and imagine that they are lined up along a spectrum from most sweet to least sweet. Assume further that the sweetness of cereals is the only difference that matters to consumers. Now suppose that Honeycomb, a new cereal that is between Sugar Smacks and Life on the sweetness spectrum, is introduced into the market. In Campbell's model the maker of Life can protect itself from Honeycomb's competitive challenge by altering Life so that it becomes more like Honeycomb. But Campbell assumes that Life will increase the sweetness of its product only long enough to assure that there will be no market for Honeycomb. When Honeycomb is driven from the market, Life will return to its less-sweet, preentry position. Thus, by temporarily changing the sugar content of its product the makers of Life cereal are able to shield themselves from the competition of potential rivals without having to sell their product at a predatory below-cost price. Because such predatory product changes do not require predators to incur greater losses than their prey, we finally have a theory of predation that seems plausible.

The problem with Campbell's analysis is that he makes no convincing case that such temporary predatory alterations actually occur. Campbell's hypothetical case raises two questions. First, would a sufficient number of consumers prefer a cereal with a sweetness level between Sugar Smacks and Life to create a viable market niche? Second, if a viable market niche exists, which firm can fill it most efficiently?

If the demand for a cereal sweeter than Life is insufficient to create a viable market niche, then Life need not react. Honeycomb will exit of its own accord, and Life will not have risked alienating existing customers by changing (albeit temporarily) the taste of its cereal.

If there is sufficient demand for a breakfast cereal with a sweetness level between Sugar Smacks and Life, then such a cereal will be offered. In Campbell's scenario the successful predatory incumbent will abandon the new market niche and return to its old niche once the aspiring entrant quits the scene. But Campbell has described a predatory unicorn. Such return movements by the incumbent will not occur if consumer demand is sufficient to justify production of the new cereal, for abandoning this mar-

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ket merely reopens the door to potential entrants. Only the question of who will provide the new cereal—Honeycomb or Life—remains. Does the maker of Life have any particular advantage in providing this sweeter cereal than does the maker of Honeycomb?

If the incumbent has no particular cost advantage, it will have no greater power to keep Honeycomb out of this market niche than Honeycomb will have to keep Life out. If the incumbent does have a cost advantage over the entrant, the incumbent will keep the entrant out. But that is all to the good; consumer welfare is enhanced when only the most efficient producers supply consumers' needs.

Campbell's cereals story is, of course, hypothetical. FTC staffers John Hilke and Philip Nelson have argued that a real-world example of nonprice predation occurred in the 1970s when General Foods, the maker of Maxwell House coffee, sought to protect its market share in the eastern United States from Folgers. At the time, Folgers used "Mrs. Olsen" as its spokeswoman. General Foods responded by introducing "Cora" as the spokeswoman for Maxwell House, a move Hilke and Nelson classify as predatory. General Foods also created a "fighting brand" named Horizon that was intentionally designed to taste more like Folgers than did Maxwell House. In addition, General Foods took several other actions identified by Hilke and Nelson as predatory. General Foods attempted to preempt Folgers coupons (for example, by mailing a 25-cent coupon first class in August 1972 to compete with a September Folgers coupon), offered lower-price specials on larger cans of coffee (to remove consumers from the market for longer periods), increased its advertising and changed the ad copy to make Folgers' advertising less effective, and used bonus gifts, such as teddy bears, to attract customers. Folgers responded with similar strategies, experimenting with trial samples of its product in limited geographic areas, for example.

Another example of supposed nonprice predation was the FTC's "cereals case" in the 1970s in which Kelloggs, General Foods, General Mills, and Quaker were accused of monopolistically deterring entry into the ready-to-eat cereals market through "brand proliferation." This strategy was supposedly designed to fill up all the available product space so that no room remained for new entrants.

In 1982 the Sixth Circuit Court of Appeals ruled that advertising by Borden to promote the brand name of its ReaLemon product was a monopolization tactic because such advertising caused what Campbell has labelled "induced brand preference." The court was concerned that "ReaLemon's successfully differentiated brand name, extensive advertising, and ability to command a premium price also acted to some degree as a barrier to entry into the processed lemon juice market."

Economic theory arbitrarily defines "competition" as a market structure in which the number of firms is large enough to force each industry to charge a price equal to its cost. In this theoretical "competitive" market, firms compete only by lowering their prices because their products are identical.

It is not clear that nonprice predation attempts are as costless to predators as proponents of these theories assert. But for present purposes let us accept the claim that so-called nonprice predation does not require the predator to absorb larger losses than its prey. It still does not follow that such strategies are a ticket to consumer-welfare-reducing monopoly power.

Unfortunately, economic theory arbitrarily defines "competition" as a market structure in which the number of firms is large enough to force each industry member to charge a price equal to its cost. In this theoretical "competitive" market, firms compete only by lowering their prices because their products are identical. No quality differences or recognition of differences in consumer preferences (for sweet or less sweet cereal, for example) are allowed.

In the real world consumers seem to prefer markets that deviate from the economists' definition of perfect competition. Consumers benefit from product advertising and a range of choices among competing goods. Because consumers value differentiated quality, markets that exhibit such characteristics are "imperfect" only because theorists or bureaucrats define them as such. An "imperfectly competitive" market is

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nothing more than a market in which producers do not limit their competitive efforts exclusively to changing prices. There is no reason to believe that such a market can be made more "competitive" without reducing consumer welfare.

The observation that innovation, advertising, and product differentiation can lead to some firms' exercising limited market power is simply a recognition that not all firms improve the quality of their products and promotions with equal speed and sensitivity to consumer tastes. Of course, successful product innovations and advertising campaigns will cause consumers to shift their expenditures from one product to another. Some firms may even gain enough advantage over their rivals to allow the successful firms to charge prices above their costs. So what? This is what making better mousetraps is all about.

For any competitive strategy to be successful, consumers must feel that they have benefitted. If consumers were not made better off by Maxwell House's efforts, they could ignore the Cora commercials, the new brand, the coupons, and the offer of free teddy bears and switch to Folgers anyway. Similarly, the practice of providing a variety of breakfast cereals can harm rivals only if consumers believe that they gain from having a large variety of cereals from which to choose. If more and different brands of cereals have little or no value to consumers, "brand proliferation" will be an unprofitable strategy. The same is true of Borden's promotion of its ReaLemon brand name. The only conceivable way a rival can be harmed by such promotion is if consumers benefit from the existence of a well-promoted brand name—which, of course, provides information and quality assurance to consumers. Advertising does not cast hypnotic spells over consumers that cause them consistently to behave irrationally. In the long run brand preferences are the result of consumer satisfaction with branded products.

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Many authors of nonprice predation theories will immediately respond that any such certainty that consumers are made better off exists only in the short run. If a firm that advertises heavily forces its rivals (or potential rivals) to abandon the market, for example, consumers will be harmed in the long run because their initial favorable response to the advertising allowed the advertiser to acquire monopoly power. Would consumers respond as positively to Cora if they knew that their increased demands for Maxwell House would eventually give Maxwell House monopoly power?

It is true that insofar as entry into markets is not instantaneous, voluntary consumer responses today might very well lead to net consumer losses in the future. But no public policy can successfully mitigate this problem. Any attempt to guard against net long-term losses would require bureaucrats and the courts to distinguish between consumers' responses that will lead to net reductions in consumer welfare and those that will not. To make such distinctions public policy authorities would first need an accurate measure of the aggregate net benefit to consumers from today's product innovations or promotional efforts. Then authorities would need to estimate both the likelihood that the nonprice competitive activities will lead to market power and the extent of the market power—its magnitude and duration. Without comparing the consumer benefits of nonprice activities (which we know to be positive) with the possible future costs of increased market power, neither bureaucrats nor the courts can hope to guard successfully against only those nonprice strategies that reduce long-term welfare rather than increase it.

The market itself actually contains a built-in policing mechanism that, if not perfect, is surely less imperfect than dependence on public officials and the courts. If a firm's nonprice strategies in a particular market are likely to lead to future monopoly power, entrepreneurs and investors have every incentive to remain in, or plan to enter, the market. Long-term monopoly is thus avoided.

Of course, real-world entrepreneurs and capital markets sometimes err in their assessments of the profitability of entering a market because they underestimate the possibility that an in-

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cumbent's nonprice strategies will eventually result in monopolization. But if entrepreneurs and investors with personal financial stakes riding on their accurate readings of the markets are prone to such mistakes, what reason is there for believing that bureaucrats or the courts will be more astute at predicting future conditions in the market? It is unrealistic to suggest that courts and bureaucrats, subject as they are to political pressures, can do a better job than entrepreneurs and investors of separating potentially harmful nonprice strategies from beneficial ones.

Raising Rivals' Costs

An especially interesting theory of nonprice predation has been advanced in the "raising-rivals'-costs" literature, attributable mainly to the efforts of Steven Salop. Rather than focusing on changes in the firm's product or promotional strategies, this literature considers aspiring monopolists' attempts to gain monopoly power by interfering in input markets.

The premise of the raising-rivals'-costs theory is that firms can interfere in input markets in ways that reduce the profits of rivals. That is, by taking actions that force rivals' costs to rise by more than their own costs, predatory firms can place their competitors at a disadvantage. Suppose, for example, that Tropicana wants to get rid of its rivals in the orange juice market. It can do so, according to the raising-rivals'-costs theorists, by purchasing exclusive rights to all oranges or at least to all of the juiciest oranges.

To raise its rivals' costs successfully, the predatory firm must be able to purchase a key input (oranges for orange juice, for example) at a lower cost than its rivals must pay for the input. If this condition prevails, the firm with access to the lower-cost input source will enjoy a competitive edge over its rivals, even if the advantaged firm is no more efficient than its rivals at transforming the input into outputs.

There is no need here to explain in detail each of the four different methods theorists identify as ways to raise rivals' costs. (These methods do have catchy names, however. There is bottlenecking, real foreclosure, the cartel ringmaster technique, and the Frankenstein monster.) Common to all methods is the ability of the predatory firm to enter into exclusive contracts with lower-cost suppliers that prohibit rivals from acquiring the input (or a substitute input) at a price as low as that paid by the predator. All four methods for raising rivals' costs are subject to the same general criticisms.

"That's settled, then. We'll lower our standards to meet the competition."

Drawing by Weber: © 1989; The New Yorker Magazine, Inc.

The weakest link in these theorists' chain of reasoning is their inadequate treatment of potential counterstrategies by rivals. All methods of raising rivals' costs depend on the ability of a predator to secure contracts that exclude its rivals. Such a result requires that the predator's rivals and its suppliers remain ignorant about its intentions.

But why would suppliers of a low-cost input cooperate with a predatory firm? It is in the interest of suppliers to alert their other customers to the actions of the predator to encourage competing customers to bid up the price the suppliers receive. Thus, rivals are likely to be aware of the predator's attempt to corner the market on the low-cost input. Once the predator's rivals en-

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ter the bidding war for the low-cost input, no firm will gain a competitive advantage over the others.

Raising-rivals'-costs theorists offer three responses to this argument. First, they suggest that counterstrategies on the part of rivals will be ineffective because exclusion is generally the dominant strategy. Competition is said to be a public good. Thus, although aggregate consumer and supplier losses exceed total monopoly profits of the predator, individual consumers cannot be counted on to contribute to the effort to buy out the monopolist. Rival firms will therefore lack the resources necessary to thwart the predator. Second, these theorists assert that predatory downstream firms can indeed acquire exclusive rights to the low-cost input by paying the input producer not to produce. And third, this theory's advocates argue that even if the predatory activity merely intensifies competition for inputs (and thus raises the price of the input to all input users), consumer welfare is diminished because the cost of producing the final product is higher than it would have been. I address each of these arguments in turn.

Exclusion as the Dominant Strategy. According to leading raising-rivals'-costs theorists Thomas Krattenmaker and Steven Salop, counterbidding for the low-cost input by rivals will block the exclusion attempt only if consumers contribute to the rivals' bidding efforts. But because consumers are generally unorganized, a free-rider problem exists, and consumers will not contribute sufficiently to rivals' efforts to enable them to outbid the predator. Because rivals' losses are typically less than the predator's gains, the predator will be able to outbid its rivals for exclusive rights to the low-cost input.

In assessing exclusion as the dominant strategy, the appropriate comparison is the cost of supply contracts to the predator relative to the cost of similar contracts to rival firms.

This argument is flawed. The primary problem is that proponents of this theory implicitly assume that the low-cost input is already monopolized. The question effectively posed by these theorists is whether rivals (without the assistance of consumers) can afford to pay an existing monopolist to give up its exclusive access to the low-cost input. In such a situation no competitive firm can bribe a monopolist to sacrifice its monopoly.

But this observation is beside the point. The object of the theory of raising rivals' costs is to explain how a monopoly can be generated by the interference of downstream firms in input markets. Rivals of an aspiring monopolist do have the incentive and the ability to block monopolizing attempts by their competitor.

The appropriate comparison is the cost of supply contracts to the predator relative to the cost of similar contracts to rival firms. This comparison indicates that rivals can take effective steps to block the predatory scheme. Competition among downstream firms for exclusive supply contracts takes place in two different ways. (Note that for this theory to explain how input-market predation can generate monopoly power, it must begin by assuming that the low-cost input is supplied competitively. If the analysis begins with the assumption that the supply of the low-cost input is monopolized, then all monopoly profits will already have been extracted by the input monopolist.)

First, each of the several suppliers of the low-cost input will receive bids for supply contracts from more than one firm. This will make it difficult for any single downstream firm to obtain an exclusive-rights contract from any one of the input suppliers. If Farmers Brown, Black, and Green own orchards supplying the world's juiciest oranges, for example, then each farmer can expect to receive purchase offers from Tropicana, Minute Maid, and other orange juice makers. There is no reason to believe that any of these orchard owners will necessarily agree to sell his entire crop to a single orange juice maker.

Second, even if an input supplier finds it advantageous to deal only with one downstream firm (Farmer Brown agrees to sell all his oranges to Minute Maid, for example), it is unlikely that a single orange juice maker will outbid its rivals for the exclusive right to purchase the entire crops of all the orange growers. All firms can compete for inputs by competing for supply contracts (whether they are exclusive-dealing contracts or not) from the several low-cost input producers.

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Because input suppliers are assumed to be competitive, competition among downstream firms for supply contracts is not competition for the bundle of all available units of the low-cost input. The existence of several sellers of the low-cost input, along with the existence of several competing bidders for supply contracts, suggests the difficult task faced by a single downstream firm seeking to purchase exclusive rights to all units of the input. The fact that consumers will not contribute to an effort to bid a monopoly away from a predator does not imply that equally efficient rivals will be unable to block attempts by predators to monopolize markets by purchasing exclusive supply contracts for all low-cost inputs.

The Low Costs of Exclusion. The second argument of raising-rivals'-costs theorists is that the predator can pay suppliers to exclude rivals at a price that is attractive both to the predator and to the input suppliers. Krattenmaker and Salop offer the following hypothetical example: "Suppose that competitive suppliers have been charging a rival the competitive input price (equal to marginal cost) of $200. Suppose the purchaser then offers to pay them a consideration of $50 for each unit by which they reduce their sales to the rival. Thus, the suppliers would raise their total unit price to the rival to $250, $50 for the right to buy and $200 for the input." Presumably, the predator convinces input suppliers to allow it alone to buy the input at some price lower than $250 (otherwise the predator's costs would be the same as its rivals). In this way rivals' costs are seemingly raised by $50 above the predator's costs, even though the predator pays only a fraction ($50) of the competitive price of the unused inputs to raise its rivals' costs.

Input suppliers benefit because they receive $50 for every unit of the input not sold to the predator's rivals. Assuming the cost of keeping the input unproduced or unextracted is zero, the input suppliers clear $50 for each unit not purchased by the predator and not sold to the predator's rivals. This form of predation appears to be an inexpensive way of acquiring monopoly power.

Of course, this exclusionary method will also be attractive to the predator's rivals. Nothing stops rivals from offering input suppliers $51 in return for the promise not to sell to the predator. The predator can then counter with an offer of $52, which rivals will counter with an even higher offer, and so on. The end result is that, even if a single downstream firm emerges as a monopolist, that firm will earn nothing more than normal profits. Only the owners of the low-cost input will have benefitted from this bidding war.

The existence of several sellers of the low-cost input, along with the existence of several competing bidders for supply contracts, suggests the difficult task faced by a single downstream firm seeking to purchase exclusive rights to all units of the input.

The Competitive-Harm Argument. Conceding, for the sake of argument, the possibility that attempts to raise rivals' costs may ultimately prove unsuccessful because of rivals' counterstrategies, Krattenmaker and Salop assert that even unsuccessful attempts to raise rivals' costs can create a monopoly advantage for predators: "If rivals must pay the additional cost of admission to avoid cost increases from exclusion, then the admission fees themselves will serve as the cost-increasing devices. The predator would gain the power to raise price from its rivals' increased costs due to the admission fees rather than by forcing them to buy from more expensive sources of supply. Indeed, the predator would prefer this outcome, since rivals' costs would be increased at a lower cost to itself."

But why would the predator prefer this outcome? After the bidding for low-cost inputs has ended, no firm has a competitive edge over its rivals. For the predator to benefit in this situation, the predator must be able to avoid the "admission fees" that rivals pay, but there is no explanation for how the predator gains such a differential advantage over its rivals.

Concluding Thoughts

Any believable theory of private market predation must explain how predators acquire advantages over rivals when such advantages are not the result of superior efficiency. Raising-rivals'-costs and other nonprice predation theo-

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ries attempt to offer such an explanation. On close scrutiny, however, proponents of these theories merely assert that if a firm can gain a non-efficiency-based advantage over rivals, then the firm will earn monopoly profits, and consumer welfare will diminish. This is true but unremarkable. Until they can offer a plausible explanation of how predatory firms can raise rivals' costs or otherwise disadvantage efficient rivals in the real world, predation theorists have not made an adequate case for government intervention.

Until they can offer a plausible explanation of how predatory firms can raise rivals' costs or otherwise disadvantage efficient rivals in the real world, predation theorists have not made an adequate case for government intervention.

Where does this leave us as we begin the second century of antitrust enforcement? Quite simply, antitrust authorities and the courts should ignore predation claims. The case for active antitrust policy in this area will remain weak until someone persuasively demonstrates that bureaucrats and the courts have generally better knowledge than entrepreneurs and investors about the day-to-day workings and future possibilities of markets. There is also a need to prove that government's antitrust enforcement powers will seldom be used to protect politically influential special-interest groups. Neither statement describes reality. Consequently, there is no respectable place in our economy for government's operating as the predation police.

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Private Antitrust Enforcement

Compensation, Deterrence, or Extortion?

William F. Shughart II

Both the Sherman and the Clayton Acts allow "any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws . . . [to] recover three-fold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee." In addition to private individuals, the term "person" has been interpreted to include corporations, partnerships, and other business entities as well as municipalities, states, and foreign governments.

The right of private parties to sue under the antitrust laws has been circumscribed somewhat by judicial decisions requiring that the antitrust injury be "direct." For example, third parties that pay higher prices because of anticompetitive acts or practices, customers of fringe firms that charge the cartel price without being direct parties to the price-fixing conspiracy, and competitors injured by the lower prices made possible by a merger, even a merger held to be unlawful, have all been denied the right to sue for treble damages.

Despite such limitations, private suits are clearly where the action is in antitrust, at least since the early 1960s. Unfortunately, the available data on private antitrust litigation are very poor. Except for matters in which there is a reported decision, no record exists of the private cases filed before 1938. By most accounts, though, private antitrust suits were uncommon before 1960, and few plaintiffs were successful. One estimate suggests that a decision was reached in only 158 private damage suits between 1890 and 1940; another places this number at 175. It is estimated that about 423 private cases were initiated over this entire period, with plaintiffs prevailing in only 13 of the reported decisions. There were 619 private cases reported between 1940 and 1959, and the plaintiff was successful in just 20 of the 144 private antitrust decisions recorded between 1952 and 1958.

Nothing in the historical data presaged the explosion in private antitrust litigation that began in 1960. Since then, the number of private cases filed annually has consistently outpaced government law enforcement efforts by a wide margin. Indeed, more than 1,000 private antitrust suits have been initiated every year since 1971 (see Table 1).

The reasons for this dramatic increase in private antitrust litigation are not well understood.

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Table 1: Private and Public Antitrust Cases Commenced, 1960–1984

Year	Private Cases	Public Cases[a]	Ratio[b]	Year	Private Cases	Public Cases[a]	Ratio[b]
1960	228	61	3.7	1973	1,125	73	15.4
1961	378	54	7.0	1974	1,230	66	18.6
1962	2,005	71	28.2	1975	1,375	59	23.3
1963	380	35	10.9	1976	1,504	69	21.8
1964	363	35	10.4	1977	1,611	56	28.8
1965	472	63	7.5	1978	1,435	57	25.2
1966	722	55	13.1	1979	1,234	63	19.6
1967	543	46	11.8	1980	1,457	78	18.7
1968	659	62	10.6	1981	1,292	37	35.0
1969	740	57	13.0	1982	1,037	40	25.9
1970	877	65	13.5	1983	1,192	63	18.9
1971	1,445	68	21.2	1984	1,100	55	20.0
1972	1,299	88	14.8				

[a] Antitrust cases instituted by the Department of Justice plus restraint-of-trade cases brought by the Federal Trade Commission under Section 5 of the FTC Act.
[b] Private cases/public cases.

Treble damages have been held partly responsible, but this remedy was available from the beginning. Several procedural changes were adopted during the 1960s, including new rules governing class-action suits, but these changes do not seem to have been significant enough to have triggered the dramatic rise in private litigation.

It is worth noting that many private antitrust suits follow successful government prosecutions; a single government case often spawns a large number of private damage suits against the same defendant. In the electrical equipment conspiracy case decided in 1962, for example, private litigants filed some 2,233 treble-damage actions against the coconspirators in the wake of the government's victory. Two-thirds (986 of 1,456) of the private antitrust cases commenced between 1946 and 1963 were preceded by successful Justice Department prosecutions of the same defendants. Private plaintiffs often free-ride on public law enforcement efforts by suing for treble damages after the respondents have been found guilty in a government antitrust case. In fact, section 5(a) of the Clayton Act declares that a "final judgment or decree . . . to the effect that a defendant has violated" the antitrust laws "shall be prima facie evidence against such defendant" in subsequent private suits. Much private antitrust litigation centers, therefore, on resolving claims of injury and calculating consequent monetary damages instead of focusing on proving guilt.

The treble-damage remedy in private antitrust suits promotes protracted litigation, encourages nuisance suits designed to extort large monetary settlements, and creates perverse incentives that magnify rather than mitigate the social cost of monopoly in the economy.

Enough is known about private antitrust suits to make them a growing cause for concern. Richard Posner has written that the "burgeoning of the private antitrust action has induced enormous, and I think justified, concern about the overexpansion of the antitrust laws and their increasing use to retard rather than promote competition." Critics contend that the treble-damage remedy promotes protracted litigation, encourages nuisance suits designed to extort large monetary settlements, and creates perverse incentives that magnify rather than mitigate the social cost of monopoly in the economy. William Baumol and Janusz Ordover have recently suggested that treble damages "provide a direct incentive for protectionist activity," that is, an incentive for using the antitrust laws in anticompetitive ways.

If that is not enough, the direct costs of private

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antitrust litigation can be staggering. Steven Salop and Lawrence White estimated that litigation costs average $200,000 to $250,000 per case, or approximately $250 million per year for all private suits filed in recent years.

The number and cost of private antitrust suits raise important questions about the role played by private parties in the enforcement of the antitrust laws. Yet private antitrust cases have been the least studied (and therefore the least understood) aspect of the enforcement process.

One of the most troubling aspects of private antitrust enforcement is the frequency with which firms bring suits against their competitors. Of course, it is possible that specialized business knowledge puts competitors in the best position to spot unlawful activities. But another possibility is that firms employ the antitrust laws as a weapon to handicap their successful rivals: firms attempt to win in the courts what they are unable to win in the open marketplace. I examine the latter possibility in some detail and show how firms might fruitfully employ the antitrust laws to their own advantage.

Incentives to Sue, Settle, and Litigate

There is a long-standing debate about the purpose of private antitrust enforcement. One side sees its main objective as enabling parties harmed by anticompetitive acts or practices to receive compensation for injuries sustained (that is, to be made whole by recovering the monetary damages they have suffered). Another viewpoint holds that private antitrust enforcement should help provide deterrence, that is, it should help prevent law violations from occurring in the first place.

The decision to commit any crime, including a violation of the antitrust laws, can be described as a solution to a cost-benefit problem. The prospective criminal compares the expected gain from illegal activity with the expected cost, where the cost is the penalty assessed if the violation is detected and punished. As such, obedience to the law can be taken for granted only if the rate of return to crime is negative. If detection and punishment are certain, the penalty required to deter a law violation will be less than if the law enforcement process works only imperfectly. If not all those who break the law are caught, or if punishment is uncertain even when a violation is uncovered, then the penalty must be increased to maintain a given level of deterrence.

Injured parties deciding whether to sue also face a decision problem involving a comparison of the expected damage award with the cost of pursuing the suit. Under what conditions will private parties harmed by antitrust violations sue to recover damages, and what factors determine whether the adversaries will litigate their dispute or settle out of court?

One of the most troubling aspects of private antitrust enforcement is the frequency with which firms bring suits against their competitors. It is possible that specialized business knowledge puts competitors in the best position to spot unlawful activities. It is also possible that firms attempt to win in the courts what they are unable to win in the open marketplace.

Decisions concerning whether to sue, and then whether to litigate or to settle, depend on the maximum amount the defendant is willing to offer in a settlement. This, in turn, depends on the defendant's expectations about the probable size of court-awarded damages plus litigation costs. Uncertainty clearly plays an important role in the positions of both plaintiffs and defendants. More precisely, differences in the adversaries' perceptions of the plaintiff's probability of success should litigation occur heavily influence the method of dispute resolution. Litigation will be more likely the more optimistic the plaintiff, the lower the defendant's estimate of the plaintiff's probability of success, the larger the judgment at stake, and the lower the competing parties' legal costs. Note that if both parties form the same estimate of the plaintiff's probability of winning, no matter how high or low the estimate is, the suit will be settled out of court because settlement avoids the cost of litigation. Litigation is only rational when the extent of disagreement about the expected outcome exceeds the cost of trial.

The data concerning private antitrust suits consistently show that a large proportion of

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these disputes are settled rather than litigated. William Baxter, for example, found that nearly 82 percent of the 671 private antitrust cases disposed of between 1964 and 1970 were resolved by settlement between the two parties. Similarly, after analyzing detailed information concerning more than 2,350 private antitrust cases filed between 1973 and 1983, Salop and White found that 73 percent of the suits were settled before reaching trial. These numbers are made more remarkable by the fact that plaintiffs appear to have a low success rate in those cases that actually proceed to a final court judgment. Baxter estimated that plaintiffs win final judgments only 15 percent of the time. Salop and White, examining a later time period, placed the proportion of plaintiffs' wins at 28 percent.

The tendency for private antitrust suits to be resolved through settlement implies that the defendants typically view their financial exposure at trial to be unacceptably high because of the expense of litigation or the size of the expected judgment or both.

The tendency for private antitrust suits to be resolved through settlement implies that the defendants in these matters typically view their financial exposure at trial to be unacceptably high. This could be due either to the expense of litigation, which the defendant will bear regardless of the verdict, or to concern about the size of the expected judgment, or both. Indeed, the data suggest a significant disparity between the expected value of litigated antitrust suits to private plaintiffs and the corresponding financial exposure of defendants

In the 28 percent of the private antitrust suits that proceeded to a final judgment in the plaintiff's favor between 1973 and 1983, the average award was $456,000 (in 1984 dollars and excluding one case in which the award was very large). On average, then, the plaintiff in an antitrust trial had a 28 percent chance of winning $456,000. If we assume that the plaintiff's legal costs (which would be borne by the plaintiff 72 percent of the time) represented 20 percent of this figure (or $91,200), then the average plaintiff's net expected gain from pursuing a private antitrust case through a court trial was $62,000.

On the other hand, the defendant in these cases faced a 28 percent probability of having to pay damages of $456,000 plus the plaintiff's legal costs. If we assume that the defendant would incur similar legal expenses from litigation, the average defendant's expected financial exposure at trial was $244,400. For the average case, then, both parties would be inclined to settle out of court for some figure between $62,000 and $244,400.

Initiating a private antitrust suit thus appears to be a profitable strategy for the average plaintiff. Whether this is so because uncertain legal standards in antitrust cases lead defendants to form relatively high estimates of plaintiffs' chances of success, because the treble-damage remedy raises the stakes to an unacceptable level, or simply because litigation is costly, the possibility exists that the divergence in expected values between plaintiff and defendant will be exploited in the form of "nuisance" suits by plaintiffs or, even worse, attempts to extort large settlements from profitable enterprises.

Extortion by Litigation

The decision to "invest" in antitrust as a method of competition is no different from any other capital-budgeting problem the firm confronts. Faced with a loss of sales to a new or established rival, the firm can respond by cutting price, by improving product quality, by increasing its advertising expenditures, or by taking any of a number of other actions that characterize the normal workings of a competitive market economy. Alternatively, the firm can appeal to the government for protection. It can lobby for favorable legislation, attempt to influence a bureaucratic ruling, or instigate an antitrust lawsuit either on its own or by supplying information about possible violations to the public antitrust enforcers. Which of these various options is chosen in any given circumstance is primarily a matter of selecting the strategy offering the highest expected rate of return to the firm.

In short, *the power residing in the antitrust laws to declare illegal certain business practices thought to be anticompetitive is also a power that can be used to subvert the competitive process.* A law that declares mergers to be illegal where they would tend to create a monopoly can be used to prevent

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Drawing by S. Harris: © 1978; The New Yorker Magazine, Inc.

mergers that will make life uncomfortable for rivals by promising to generate substantial cost savings. A law that declares selective price cutting to be illegal where the effect would be to injure competitors unfairly can be used against a rival that, by virtue of superior efficiency, is able to offer lower prices to customers.

The interest-group theory of government teaches that whenever a public policy process can be mobilized to benefit selectively the few at the expense of the many, those who can gain from that policy will use it strategically. This is not to say that such behavior represents a misuse or abuse of the policy process in any meaningful sense. Rather, the pursuit of wealth transfers (or the defense of existing wealth) through the antitrust laws simply reflects rational, self-interest-seeking behavior under given constraints. Nor is it necessary to inquire into the motives of the framers of antitrust. Whether antitrust was designed as a wealth-transfer mechanism or, instead, transfer-seeking is an unintended or unforeseen consequence of a policy meant to promote consumer welfare, the antitrust laws do offer a mechanism by which firms can benefit themselves at the expense of their rivals and the consumers of their products.

Consider Section 7 of the Clayton Act, which declares mergers between horizontal competitors to be illegal "where the effect is to substantially lessen competition or tend to create a monopoly." Many mergers result in the closure of outmoded production facilities, the replacement of incumbent managers, the combination of duplicative product distribution networks, and other synergistic effects that promise to reduce costs. Increased economic efficiencies of this sort will increase the wealth of the owners of the firm targeted for takeover and will benefit consumers by allowing the product to be produced and sold more cheaply. At the same time, however, rival sellers are faced with the prospect of increased competitive pressures. They can respond by attempting to emulate the organizational innovations the merger partners plan to implement or by taking other steps to lower their own costs. Alternatively, the competitors, complaining of a possible violation of the merger law, can sue. They will almost surely be joined in the antitrust action by the managers and employees who stand to lose their jobs and by local public officials in the areas where plant closures are scheduled. These demands for protectionism can be met if the antitrust authorities and the courts can be induced to adopt a sufficiently narrow market definition such that the market shares and market concentration levels generated by the proposed merger go beyond the thresholds required for finding a merger law violation.

Whether antitrust was designed as a wealth-transfer mechanism or transfer-seeking is an unintended consequence of a policy meant to promote consumer welfare, the antitrust laws do offer a mechanism by which firms can benefit themselves at the expense of their rivals and the consumers of their products.

Of course, it is possible that opposition by competitors to a proposed merger could arise from a public-spirited attempt to check an increase in monopoly power that reduces consumer welfare. After all, rivals will have access to the specialized information about market conditions necessary to distinguish between mergers that enhance efficiency and those that increase market power. Surely the antitrust authorities and the courts should be able to see through and reject competitors' complaints that are nothing more than self-serving attempts to handicap their rivals.

Neither of these possibilities, however, seems consistent with the facts in private antitrust case law. One example is sufficient to illustrate the power of antitrust to subvert competition. In 1983 General Motors Corporation and Toyota

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sought to enter into a joint venture to produce a new subcompact automobile in the United States. The plan involved combining GM production facilities in Fremont, California, with Japanese-supplied engines and Toyota's designs and managerial expertise to produce an American version of the Toyota Corolla. GM claimed that the venture would generate substantial economic benefits by allowing its managers to learn from Toyota the secrets that make Japanese automobile manufacturers more efficient than their U.S. counterparts. GM would presumably then seek to apply those secrets in its other plants.

The 1983 petition by Chrysler and Ford for the FTC to halt a joint venture by their competitors, GM and Toyota, to produce a new subcompact car is an example of the power of antitrust to subvert competition. The joint venture was ultimately approved, but GM and Toyota were ordered to limit their production of the new vehicle.

Soon after the agreement was announced, both Chrysler and Ford, the horizontal competitors of GM and Toyota, petitioned the Federal Trade Commission to halt the joint venture. Chrysler and Ford argued that the combination of two of the world's largest automobile companies would substantially lessen competition in two ways. First, they contended that because GM and Toyota proposed to set the price of the new vehicle by reference to the average price of other specified subcompact car models they produced, the exchange of information between the two firms would facilitate collusion. Second, Chrysler and Ford alleged that the joint venture would increase GM's market power in the market for larger-sized automobiles. To substantiate their argument, Chrysler and Ford presented results from marketing studies showing that consumers exhibit a high degree of brand loyalty. As the incomes of first-time car buyers increase over their lifetimes, they tend to "trade up" to a more expensive model produced by the same manufacturer. For this reason, auto makers allegedly regularly sell subcompact cars at lower margins with the expectation of higher future sales of large vehicles at higher profit margins. Chrysler and Ford claimed that sales of the joint-venture vehicle, which was to be distributed through GM's franchised dealers, would allow the firm to "lock in" additional customers to its product line so that GM would eventually capture a greater share of the market for larger automobiles.

Chrysler and Ford's opposition to the GM-Toyota joint venture illustrates what may be a general principle of antitrust analysis, namely that opposition by horizontal competitors is prima facie evidence that the challenged practice promotes competition. If, as Chrysler and Ford claimed, the GM-Toyota agreement would have facilitated collusion or increased GM's monopoly power in any segment of the domestic automobile market, then their silent acquiescence would have been expected. Any attempt on the part of the joint venturers to charge supracompetitive prices would present the horizontal competitors—Chrysler and Ford—with two profitable options. They could either raise their prices as well or they could maintain their prices at existing levels and thereby gain sales at the expense of the colluders. On the other hand, complaints by rivals are predictable if the joint venture is likely to result in lower cost or improved product quality. In that event market forces place rivals at a competitive disadvantage. As Baumol and Ordover have observed, excluded competitors must then "run correspondingly faster . . . to stand still."

The FTC ultimately approved the GM-Toyota joint venture. But, the commission also provided Chrysler and Ford with an important victory by ordering GM and Toyota to limit their production of the new vehicle to no more than 250,000 units per year. This output restriction, which is hardly consistent with antitrust's stated goal of promoting consumer welfare, prevents GM and Toyota from taking full advantage of prospective scale economies and thus results in higher average production costs than might otherwise have been realized. Such an outcome is, however, consistent with a prediction of the interest-group theory of government, namely that no one interest group will get all that it wants from regulation.

The GM-Toyota matter was not an isolated incident. Private antitrust cases tend overwhelm-

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ingly to fall into two basic categories: suits filed by firms charging their competitors with unlawful conduct and suits filed by downstream business entities—dealers, business customers, franchisees, and licensees—charging their suppliers with unlawful conduct.

As Table 2 shows, downstream firms as a group represented the largest category of private antitrust plaintiffs from 1973 to 1983. These complainants tended to charge their suppliers with vertical price-fixing, refusals to deal, and unlawful terminations of their business relationships. Competitors most often complained of conspiracy, predatory pricing, and other horizontal restraints of trade and were also the private parties most likely to challenge mergers and joint ventures.

The possibility that some, if not all, of these complaints were designed to extort monetary settlements from defendants arises because even if a defendant thinks that the plaintiff's suit is likely to fail at trial, it still might be rational to settle out of court for some amount less than the expected costs of litigation. Settlement becomes even more worthwhile if the defendant is concerned that a final judgment in favor of the plaintiff will invite follow-on suits or have adverse consequences for other cases, or if the plaintiff's suit seeks injunctive relief in addition to monetary damages.

There is reason to suspect that most private antitrust litigation is driven by extortion motives. Although the dimensions of the problem are far from clear, some limited evidence suggests that more benign compensation and deterrence motives simply do not explain a large number of private suits. For example, Pauline Ippolito reviewed data from 130 private antitrust cases charging the defendant with the illegal use of resale price maintenance (RPM). She discovered that 87 percent of these private RPM suits were initiated by dealers against their upstream suppliers. Most of the dealers who complained had, for various reasons, been terminated as the manufacturer's authorized distributor. (Consistent with the evidence from private antitrust litigation in other areas of the law, approximately 70 percent of the cases were settled out of court, and plaintiffs won only about 28 percent of the matters that actually went to final judgment.) Ippolito concluded that fewer than 15 percent of the private suits she examined could be explained by anticompetitive theories of vertical price-fixing: "In fact, based on a reading of the substance of the disputes, many of the private RPM cases appear to be essentially contract disputes recast as antitrust cases and embellished with a variety of antitrust charges."

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Table 2: Plaintiff's Relationships to Defendants in Private Antitrust Cases

Relationship		Frequency
Competitor		36.5%
Downstream Business Entity		51.4
Dealer	27.3%	
Customer Company	12.5	
Franchisee	1.6	
Licensee	1.3	
Final Customer or End User	8.7	
Supplier		5.6
Employee or Former Employee		3.5
State or Local Government		1.4
Other		12.7
No Information		13.8

Note: Percentages total more than 100% because a complaint may involve more than one business relationship.
Source: Salop and White (1986).

In a recent attempt to document anticompetitive uses of the antitrust law, Christopher Klein used a very narrow definition of a "sham" case. The suspect cases he identified all involved defendants in private antitrust suits who countersued the plaintiffs on the grounds that the original complaint was baseless, frivolous, or undertaken solely with anticompetitive intent. Even when requiring a countersuit to identify abuses, Klein was able to uncover 117 examples of sham litigation between 1972 and 1986. The cases Klein identified may, of course, be only the tip of the iceberg. Extortion motives are likely to be

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even more prevalent in private antitrust litigation than Klein's study indicates. Both the significant proportion of private suits that are initiated either by competitors or by firms having an existing or prior business relationship with the defendant and the high settlement rates that characterize these actions reinforce this conclusion.

The evidence, however, is far from conclusive. The high percentage of out-of-court settlements could indicate that private antitrust enforcement is a well-functioning system in which law violations are deterred and victims of illegal conduct receive compensation while economizing on costly litigation to the adversaries' mutual benefit. But as Salop and White have observed, "once the possibility of extortion is added to the analysis . . . a high settlement rate could indicate that antitrust is a blackmailer's paradise."

Concluding Remarks

The case for characterizing antitrust as a mechanism for wealth redistribution, or what Robert Bork called predation through governmental processes, is based on three distinct, but related, contributions to the literature on public policies toward business. First, it has been repeatedly demonstrated that public antitrust cases are not selected on the basis of their potential net benefits to society. Second, research has shown that the enforcement process is subject to political influences. Third, the economic literature on antitrust has been highly critical of enforcement efforts in a large number of specific cases.

The strategic use of antitrust processes to subvert competition offers advantages over conventional forms of rivalry. If the government sues a firm's competitor, the costs of litigation are shifted to the taxpayer. An antitrust decree enforced by public prosecutors and the courts affords a unique opportunity to secure protection from effective competition.

More fundamentally, however, the emerging appreciation of the incentives of some firms to use antitrust policy to subvert competition is grounded in the theories of economic regulation and rent-seeking. Interest groups that expect to receive concentrated benefits and enjoy low costs of mobilizing their members politically have an incentive to lobby for regulatory favors that increase their members' wealth at the expense of groups whose interests are more diffuse or who are less well organized. The regulators, in turn, serve as brokers of these wealth transfers in their aim to maximize political support.

The rent-seeking model simply suggests that decisions concerning the strategic use of governmental processes to secure or protect above-normal profits, or rents, is a capital-budgeting problem not unlike most other investment choices the firm must make. That is, along with conventional methods of price and nonprice competition, the investment strategies available to the firm include lobbying for favorable legislation or attempting to influence a bureaucratic ruling. Instigating an antitrust suit is just one other option in this regard. From an analytical viewpoint, all of these possible courses of action are equivalent and serve one and the same purpose, namely to gain a competitive advantage over rivals vying for access to a rent. The particular strategy chosen in any given circumstance will simply be the one that offers the highest expected rate of return.

The strategic use of antitrust processes to subvert competition offers at least two advantages over conventional forms of rivalry. If the government is induced to sue a firm's competitor, the costs of litigation can be shifted to the general taxpayer. More important, the police power of the state is brought to bear on the tasks of adjusting and monitoring the behavior of rivals. An antitrust decree enforced by public prosecutors and the courts affords a unique opportunity to secure protection from effective competition.

While antitrust may be equivalent to conventional forms of rivalry from the point of view of firms choosing among alternative competitive strategies, the options are not equivalent for the rest of us. Cutting prices or investing resources in some method of nonprice competition generates consumer surplus. Instigating a lawsuit imposes costs on the economy. There are both direct and indirect social costs involved when antitrust is used to subvert competition. Litigation expenditures comprise the bulk of the direct so-

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cial costs of rent-seeking through antitrust processes. As noted earlier, these outlays can be astonishingly high. To these costs must be added the expenses incurred by the public antitrust enforcement agencies.

The direct costs of litigation, however, are only a small factor. When faced with an antitrust challenge, the energies of the firm's managers are deflected from efforts to increase productivity or to improve product quality toward issues related to the pending litigation. The attention of the firm's internal legal counsel will be focused on taking depositions, preparing witnesses, supervising responses to subpoenas, and writing legal briefs rather than drawing up contracts with suppliers and customers. On a deeper level, executives and lawyers will be hired for their adeptness in dealing with the antitrust law rather than for their business acumen. Moreover, the priorities of the firm respecting conventional methods of rivalry will be altered in socially costly ways. Managers will hesitate to engage in the types of competitive behavior ("predatory" price-cutting or external growth through merger, for example) that risk the possibility of an antitrust lawsuit. While no estimate of the magnitude of the indirect costs of this sort is possible, they are probably several times the direct litigation costs.

The value of the resources consumed both directly and indirectly as a result of rent-seeking through antitrust processes is a net loss to the economy. Such costs are incurred in wealth redistribution rather than in income-producing activities.

The value of the resources consumed both directly and indirectly as a result of rent-seeking through antitrust processes is a net loss to the economy. Such costs are incurred in pursuit of wealth redistribution rather than in income-increasing activities. It is certainly true that lodging an antitrust complaint against a competitor may generate private benefits for the plaintiff if the rival is subsequently ordered to cease cutting prices, prevented from consummating a merger that would reduce costs, or barred from using some other "unfair" method of competition, but nothing of value is thereby created for consumers. In the limit the total cost of such activities includes both higher prices to consumers and the efficiency losses that result from insulating firms from the forces of effective competition.

It has not yet been systematically shown that most private antitrust cases are anticompetitive. The indications, however, are that the strategic use of antitrust to subvert competition is widespread. If so, Baumol and Ordover were correct when they concluded: "This is a specter that may well dwarf any other concern about the antitrust processes. We ignore it at our peril and would do well to take steps to exorcise it."

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Drilling for Dollars

The New and Improved Federal Oil Lease Program

Abraham E. Haspel

The story of the Federal Onshore Oil and Gas Leasing Reform Act of 1987 represents a modest victory for the marketplace and competition. It describes how the Department of the Interior abandoned its traditional bureaucratic methods for leasing public lands for oil and gas exploration and chose to rely instead on market forces. Although dissatisfaction with deregulation in other sectors has somewhat tarnished decontrol and marketplace competition, there have been no calls for reregulation of the onshore oil and gas leasing program. The fraud, abuse, and inefficiencies that plagued the earlier system have all but disappeared, and participants agree that the new market-based system is functioning well.

Onshore Leasing and the Lottery

Congress first passed legislation in 1920 to institute the leasing of onshore federal lands for oil and gas exploration and development. The system included both competitive and noncompetitive elements. Lands that lay within the bureaucratically drawn boundaries of a "known geologic structure" of a producing oil and gas field were leased competitively to the highest bidder. Lands that lay outside these boundaries were leased noncompetitively on a first-come, first-served basis. Before 1988 less than 5 percent of federal lands in this program were leased competitively.

This system functioned well enough until the 1950s. But leases for land outside boundaries of a producing field were potentially valuable, and competition for them did develop. Unfortunately, this competition did not occur in an organized marketplace. Rather it surfaced in illegal practices, such as the destruction of government land records; if other oilmen did not know the lands were available, they would not know to apply for them. Intimidation, including fist fights, was also used to prevent other oilmen from being first to arrive and apply to lease potentially valuable land from the Department of the Interior's Bureau of Land Management.

To restore order to the noncompetitive elements of the leasing program, the Bureau of Land Management introduced a lottery in 1959, the basic mechanics of which survived until 1987. All U.S. citizens of full legal age were eligible to apply for a lease for a nominal fee of $10 per application or filing; this filing fee was raised to $75 in 1982. Although each applicant could file only one application for a lease on any particular parcel of land, he could file on as many parcels as he chose. All filings accepted during a specified ten-day period were deemed to have been filed simultaneously, and a drawing was held to determine the winner of the

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lease. Many times the winner of the noncompetitive lottery won nothing of value. But when the lease was valuable, it was often sold or assigned to an oil company in a secondary assignment market at a price many times what the lottery winner had paid to pay.

To restore order to the noncompetitive elements of the onshore oil leasing program, the Bureau of Land Management introduced a lottery in 1959. Both the independents and the majors supported this lottery system, but the lottery encountered problems of its own in the forms of abuses by middlemen, filing agents, and 40-acre merchants.

Both the independent oilmen and the major oil companies suported this lottery system. The independents felt that the lottery helped them to overcome the handicap created by their relative lack of financial resources. Often independents were in a better position than the majors to identify potentially valuable property and to move quickly to obtain a lease through assignment. When the majors did participate in lotteries, the independents had an equal chance of winning the leases offered. And in the end, if a major really wanted a particular lease, the larger company could buy the lease from the independent. Thus, the independents viewed the system as a means of creating a "level playing field" with the majors. The majors supported the system as a means of getting potentially productive lands out of government control and into private hands.

Noncompetitive Problems Arise. But the lottery soon encountered problems of its own in the form of abuses by middlemen, filing agents, and 40-acre merchants. In 1980 it was discovered that signatures on many lottery applications and future assignment papers had been obtained by middlemen for a small payment, a drink, or the promise of continued employment. Middlemen thus built stockpiles of applications signed by U.S. citizens but with other specifics (such as the information identifying a particular land parcel) left blank. These applications could be filed wherever and whenever an order was placed by an oil company hoping to obtain exploration and development rights on a particular parcel. Using the assignments obtained with the signed applications, the middlemen could help skew the chances of winning specified leases in favor of their clients.

The second abuse involved filing services, boiler-room type operations that promised unsuspecting citizens great wealth through participation in the government-run oil and gas lottery. For a fee these filing services entered individuals in various lotteries. While they often did not violate the letter of the law, the filing services did violate its spirit and led a number of individuals to invest their life savings in lotteries that returned nothing of value. Several of these operations are now being investigated on charges of fraud by state attorneys general and the Federal Trade Commission.

The third set of problems were created by the so-called 40-acre merchants. These were the winners of worthless leases who subdivided their tracts into 40-acre parcels and sold these smaller leases to an unsuspecting public. The imprimatur of a federally obtained oil and gas lease lent credibility to these deals. This scam proved very lucrative for the merchants and troubling for the Interior Department and Congress when those purchasing the leases realized that they had been duped.

While the scandals revolving around the lottery system were disturbing, they did not generate any strong movement toward change. What did spur action was the "give-away" appearance of the noncompetitive system, an image that was the direct result of the inability to ensure that no valuable parcels lay outside boundaries requiring competitive bids.

A review of the leasing program in mid-1983 made it apparent that, despite proposed changes, the existing system provided no stability or predictability. It was impossible to eliminate the likelihood that lottery winners would receive more for their leases than the government had collected, and this generated calls for discontinuing the program. As 1983 drew to a close, it had become evident at the Interior Department that this was no way to run a leasing program. A change was needed, and incoming Interior Secretary William Clark called for an overall review of the onshore leasing program.

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The Winds of Change

In each Congress after 1980, Sen. Dale Bumpers proposed eliminating the noncompetitive elements of the onshore oil and gas leasing program. At times Rep. George Miller put forth similar proposals, but the Interior Department demurred from considering any changes that were more than cosmetic. Before 1984, steps toward increasing the role of competition were limited to trying to devise broader regulatory definitions of a known geologic structure. Anything more meant revising the Mineral Leasing Act of 1920, and this would expose the onshore oil and gas program to the whims of Congress and political pressure groups.

In early 1984, however, the Interior Department's Office of Policy Analysis and the Bureau of Land Management began to seriously consider substantive change. In addition to receiving a fair return for onshore leases, the Interior Department had five other objectives: maintaining incentives to explore for oil and gas reserves by making unproven lands available to applicants intent on exploring for and developing these resources; promoting the orderly and timely development of oil and gas resources; minimizing the administrative burden of the leasing program while maintaining its integrity; maintaining low barriers to entry so that small firms could participate in the program; and leasing environmentally suitable lands in a manner compatible with other uses, including the retrieval of other minerals.

To maximize revenues it appeared critically important to differentiate between desirable tracts and other tracts. The proposed method established two sequential tiers. First, all tracts would be offered competitively at oral auction. Those that did not receive the minimum acceptable bid would be offered noncompetitively in the next lottery.

Although the economists within the study group recommended leasing all federal lands on a competitive basis, such a response was believed to have little political support except from Sen. Bumpers' office. Consequently, a number of other ideas were advanced including requiring competitive leasing of a congressionally mandated minimum percentage of lands, requiring companies to include with their bids a commitment to a specified amount of work on the leased land, using the lottery to determine the lessee but then appraising the land to determine the price the winner would have to pay to exercise his lease, and charging different rents based on the geological potential of the leased land.

Meanwhile, in 1983 Wyoming, the state in which 50 percent of the Bureau of Land Management lottery activity occurred, changed its leasing program for state lands from one that was all noncompetitive to one that was all competitive. After two sales, it was clear that Wyoming was losing money on its decision. Because there were two kinds of tracts—the desirable or "cream" tracts and everything else—Wyoming could have raised more money by offering the cream tracts competitively and the rest noncompetitively through a lottery.

To maximize revenues it appeared critically important to differentiate between the two kinds of tracts. Work began on a market-based system within the Interior Department's Office of Policy Analysis, but rather than using a geologically based test of value as the known geologic structure system attempted to do, an economic test was devised.

The proposed method established two sequential tiers. Initially, all tracts were to be offered competitively at an oral auction. Any tracts that received a bid at or above a specified minimum bid (initially $35 per acre was suggested) were to be awarded to the high bidder without any further evaluation. Tracts that did not receive the minimum acceptable bid, including those that received no bid, were to be offered noncompetitively in the next lottery. The vast majority, 90 percent or more, of the land would still be awarded noncompetitively, but most of the money would be collected competitively. All of the Interior Department's major objectives were met by this two-tier proposal. After a series of studies by the Interior Department, on May 17, 1985, Secretary Donald P. Hodel selected the two-tier, market-based approach to reforming the onshore oil lease program.

Despite their traditional opposition to changing the system, many independent oilmen were privately beginning to rethink their position. In meeting with the leadership of several indepen-

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dent petroleum associations to sell them on the need for change, the Interior Department learned that the independents were not a monolithic political force speaking with one voice. Some feared competition; others welcomed it. One fear voiced by the independents would prove to be real, however. There was concern that opening the Mineral Leasing Act to amendment would create an opportunity for the environmental community to raise issues above and beyond the narrow question of leasing mechanics. In particular, environmentalists might press for new criteria defining which federal lands, if any, should be leased. It was feared that the Interior Department might end up with a better leasing system but no lands it could lease. And the Interior Department recognized that the prospect of additional centralized, bureaucratic land-use planning could neutralize, if not overwhelm, the benefits of a more market-oriented leasing program.

The Legislative Battles Begin. The reform of the onshore oil and gas leasing program became an important political agenda item early in the 99th Congress. Legislation introduced in both houses early in 1985 would have required the oil and gas exploration and development rights on all federal lands to be leased competitively. As representatives from the Interior Department continued to work closely with the staffs of Sen. Bumpers, Rep. Morris Udall, and Rep. Nick Joe Rahall, the two-tier, market-based approach favored by the Interior Department became increasingly viewed as a viable alternative to the all-competitive system initially favored by Bumpers and others.

Despite their traditional opposition, many independent oilmen were privately beginning to rethink their position. Some feared competition; others welcomed it. The fear that proved to be real was that opening the Mineral Leasing Act to amendment would allow the environmental community to raise issues beyond the question of leasing mechanics.

"I KNOW IT'S NOT MUCH TO LOOK AT NOW, BUT THINK OF THE POTENTIAL!"
Drawing by Cullum; Copley News Service.

On July 30, 1986, the Senate Energy and Natural Resources Committee passed a bill setting the minimum acceptable bid for competitive leasing at $20 per acre. The only reference to the environment was a note that the National Environmental Policy Act applied to virtually all aspects of the program. Despite the hearings on onshore leasing reform held by the House Subcommittee on Mining and Natural Resources, no bill was reported out of the full committee. Although the Senate sent the onshore leasing reform bill to the House twice in the waning hours of the 99th Congress, Congress adjourned without leasing reform.

The Environmental Issue Comes to a Head. When the 100th Congress convened in January 1987, leasing reform bills were introduced in both houses. The bill that emerged from the Senate committee in July 1987 represented a compromise, reducing the minimum acceptable bid for competitive leasing from the $35 per acre favored by the Interior Department to $10 per acre. This change dramatically increased the amount of federal land that would be leased competitively. The bill passed by the House included a two-tier system with a minimum bid of $2 per acre for competitively awarded leases and a five-year lease term. Any lands that did not receive this minimum bid were available noncompetitively on a first-come, first-served basis, but the lease term was increased to ten years.

In early 1987 it became evident that environmental concerns would play an important role in debates over reform of the onshore oil and gas leasing program. Despite admonitions from the Interior Department that additional environmental requirements beyond those of the Federal Land Policy and Management Act, the For-

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est and Rangeland Renewable Resources Act, and the National Environmental Policy Act would add "to the administrative burden and costs" and would require "unsupported judgments beyond what can be reasonably predictable," the House version of onshore leasing reform included considerable land-use planning restrictions, requiring not only descriptions of the oil and gas potential, but also "an analysis of the most likely social, economic, and environmental consequences of exploration and development for oil and gas recovery, . . . an identification of those specific protective stipulations to be applied to oil and gas leases, and the specific areas to which each such stipulation shall apply."

The environmental sections now dominated everyone's interest. The Interior Department and the oil and gas industry were concerned that extensive environmental restrictions would effectively stop the leasing of onshore federal lands. There was general agreement that leasing reform was not worth the environmental costs the House bill would impose.

In September 1987 Secretary Hodel wrote Reps. Udall and Rahall: "This bill, if passed as currently constructed, will impede the orderly and timely exploration and development of the public lands for oil and gas by seriously undermining the leasing process. Should this bill, or one very similar to it, be enacted by both houses of the Congress, I will recommend in the strongest terms to the President that it be vetoed." Rep. Richard Cheney noted that "all of the oil and gas drilling that has ever taken place on federal lands since the passage of the Mineral Leasing Act of 1920 has yet to disturb even *one-tenth of one percent* of the lands underlying the federal mineral estate."

A Reform Act Emerges. In both houses of Congress the reform legislation was attached to the respective budget reconciliation bills. The conference committee established to work out a compromise on onshore oil and gas leasing reform met on December 16 and 17, 1987.

In a December 15 letter to the conferees, Secretary Hodel reiterated his strong objections to additional environmental requirements and asked that the conference committee accept the Senate language setting the minimum bid for a competitively awarded lease at $10 per acre. On this latter point Hodel argued, "By setting the minimum bid at $2 per acre, little incentive is left for anyone to uncover heretofore unleased lands or to participate in a simultaneous drawing."

Although Sen. Bumpers assured officials at the Interior Department that he would support the $10 minimum bid to the bitter end, it soon became clear that reform would not occur unless he compromised on this position. The conference came down to a trading session between Sen. Bumpers and Rep. Miller. Bumpers accepted the House's $2 minimum bid with the proviso that it could be raised after two years if a report to Congress by the Interior Secretary (prepared by the Bureau of Land Management) established that raising the minimum required for a competitive lease was in the public interest. Miller conceded the environmental planning section, accepting instead congressionally mandated studies by the Government Accounting Office and the National Academy of Sciences addressing the issues raised in the land-use planning section of the House bill. With these two major stumbling blocks removed, the remaining issues were quickly dealt with and the conference concluded. On December 22, 1987, the Omnibus Budget Reconciliation Act was passed by both houses. Title III is the Federal Onshore Oil and Gas Leasing Reform Act of 1987.

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Epilogue

Passage of the onshore oil and gas leasing reform legislation marked the end of the legislative process and the beginning of the regulatory process. The first auction under the new law was held in Wyoming on March 30, 1988. The *Casper Star Tribune* reported the next day that a Government Accounting Office spokesman and the Bu-

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reau of Land Management leasing section chief concluded, "It appears the auction method did generate much more money than comparable sales under the previous combined system of lottery distribution and sealed competitive bids on prime tracts." This first auction under the new leasing program drew more than 200 bidders, leased 336 of the 867 parcels offered, and raised $7.8 million. All involved agreed that the mechanics of the auction method worked well. Noncompetitive leasing followed for tracts that did not receive bids.

The 1987 reform bill requires the Bureau of Land Management to provide annual reports to Congress on the performance of the new system. The first report, released May 2, 1989, noted that for acreage leased in fiscal year 1987 the government received an average of $8.49 per acre from bonuses and fees. In 1988, acreage leased before the new regulations were put in place received only $2.39 per acre, as potentially valuable land outside the known geologic structure of a producing field was held back until the competitive bidding system was started. Acreage leased under the reform act in 1988 received $9.96 per acre.

These trends continued in fiscal year 1989, the first full year under the reform act. Almost 7,400 parcels, covering more than 6.1 million acres, were leased. Bonuses and fees collected by the federal government amounted to $87.8 million. Although all acreage was first offered competitively, only 56 percent of the parcels and 45.4 percent of the acreage were ultimately leased through competitive bidding. It is instructive to compare onshore leasing experiences in 1989 and 1987. Under the competitive bidding program in 1989, the Bureau of Land Management leased 80 percent more acreage than in 1987, and its revenues from the program increased by 138 percent. The average return from leased land rose to $14.35 per acre. Thus, the government realized almost $6 more per acre than the pre-reform-act 1987 average. Furthermore, the independents have found themselves able to continue to compete effectively. In Wyoming, for example, independent oilmen won 85 percent of the federal leases awarded in fiscal year 1988 after the new system was in operation, and they captured almost 70 percent of the leases that went for $500,000 or more.

In short, the Interior Department seems to have accomplished its goals. The leasing program now in place relies heavily on the marketplace to establish a fair financial return for the federal government. Meanwhile, the system continues to make lands available for exploration and development. Still, there remain nagging concerns over the environmental reports of the National Academy of Sciences and the General Accounting Office.

The National Academy of Sciences' report was issued in January 1990. It found that the planning processes employed generally "have proven adequate to deal with issues related to oil and gas exploration on most Federal lands." The academy concluded, however, that controversies involving lands that are valuable both for their oil and gas potential and for their surface resources "are casting doubt on the efficacy of the planning process and threaten to bring leasing to a halt in some areas."

In its report, the academy's committee also made several controversial recommendations. The report echoed the House bill's call for forecasting reasonably foreseeable consequences of oil and gas exploration and development at the land-use planning stage. It asked that in areas that are valuable for both their surface resources and their gas potential, only exploration rights be leased, with development rights leased subsequent to exploration. The report recommended that the Bureau of Land Management and the Forest Service determine whether lands are suitable for oil and gas exploration and development and suggested that a stipulation preserving the government's right to revoke a lease become standard. The academy's report encouraged the government to control more closely the configuration and timing of leases in an area, to consider shortening the term of a noncompetitive lease, to improve public participation in de-

The leasing program now in place relies heavily on the marketplace to establish a fair financial return for the federal government. The system continues to make lands available for exploration and development. Still, there are concerns over reports that advocate environmental restrictions.

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cisions to waive, suspend, or modify lease stipulations, and to improve inter- and intraagency coordination. Finally, the academy's report suggested that the committee's recommendations be applied retroactively to existing leases to the extent possible.

The oil and gas industry is naturally concerned that recommendations such as these will limit their ability to lease federally owned lands for oil and gas exploration. While the act seems to have solved problems in the way lands are leased, it may have created another set of difficulties by restricting which tracts the federal government can lease and under what conditions.

Lessons Learned. There are several lessons to be learned from the passage of the 1987 Federal Onshore Oil and Gas Leasing Reform Act. An important step in bringing about change was the outreach program initiated by the Interior Department to discuss the proposed changes with the independents. This effort not only eased some fears about revisions under consideration, but it also demonstrated to Interior Department and congressional staffs the significant diversity of opinions among independent oil and gas producers.

It is also worth noting that the final form of the legislation was unexpected by the principal participants when the process began. Both the Interior Department and the industry had initially taken the position that a two-tier system in which noncompetitive leasing continued to play a dominant role was necessary to assure a continued role for the independent oilmen. It was generally argued that only the cream of the parcels ought to be leased competitively. While Sen. Bumpers supported this two-tier proposal, he often commented that it offered only "half a loaf." In the end, Bumpers managed to obtain almost the whole loaf.

The system introduced by the reform legislation is still two-tier, of course. But the low $2 per acre minimum bid on competitively issued leases has led to a much greater percentage of lands being leased competitively than was originally envisioned, although changed lease terms have resulted in active noncompetitive leasing too. Analysts who believed that an all-competitive solution was the efficient answer—but not a politically viable one—were pleasantly surprised at the outcome. The sequence of events that led to this result demonstrates the value of compromise, of avoiding all-or-nothing positions. A willingness to listen to the concerns of other groups and to make concessions in developing a proposed solution brought the independents to the table, allowed the notion of reform to be seriously debated, created the opportunity for dialogue, and ultimately resulted in competition for the majority of federal onshore oil and gas leases. The initial compromise broke the retaining wall that prevented change, and from it came reform legislation.

The potential for problems remains, however, even outside the concerns about the impact of proposed environmental restrictions. On May 20, 1990, the *Baltimore Sun* advertised a Wyoming oil "lottery": "Hundreds of individuals will win oil and gas lease rights in the upcoming public drawings conducted by the Bureau of Land Management. Tremendous cash gains may be realized by selling those rights to oil companies who pay lump-sum cash plus life-long royalties on all oil and gas production. Incredibly some will risk no more than a tax-deductible $45 to participate in this little-known program that allows each individual the right to compete equally with the giant oil companies for leases on public lands that may produce a fortune in oil and gas income." The initial flush of success with the Federal Onshore Oil and Gas Leasing Reform Act of 1987 must be tempered with the recognition that this story is not finished. We can only hope that future problems will not be so troublesome as those addressed by this legislation.

A willingness to listen to the concerns of other parties and to make concessions in developing a solution to the onshore leasing problem brought the independents to the table, allowed reform to be debated, created dialogue, and resulted in competition for the majority of federal onshore oil and gas leases.

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Dissipating the Airline Deregulation Dividend

The Decline of Competition at Hub Airports

Severin Borenstein

Since price and entry controls were removed from the airline industry in the late 1970s, much of the analysis of the industry has focused on determining whether consumers have benefitted from deregulation. This is unfortunate for two reasons. First, the answer is fairly clear. Most travelers are better off than they would have been had Civil Aeronautics Board price, quantity, and rate-of-return regulation continued, and the *net* benefits are certainly positive. Second, the answer has sometimes been misinterpreted in arguing either that the industry is now extremely competitive or that any remaining problems must be the fault of the government. Although consumers have benefitted from deregulation, there is less competition in the airline industry than was hoped for or is possible.

The airlines' formation of hub-and-spoke networks since deregulation represents both an important advance and a serious anticompetitive influence. Hub-and-spoke airline networks have lowered airlines' costs per passenger by allowing them to fill each flight more completely and to use their aircraft more hours per day. Hubs have also increased the number of flights offered on some city-pair routes, because the number of connecting passengers travelling on some spokes of the network is large enough to justify additional flights on that spoke. It is particulary disappointing, therefore, that construction of the hubs has also led to a decline in competition for passengers who want to fly to or from the hub cities. The average prices paid to travel to or from hub airports are not necessarily higher than they would have been under regulation, but they are usually 15 to 40 percent higher than similar trips that do not end or begin at a hub. Almost certainly fares to or from hubs would fall if there were active competition for these customers.

Declining competition at the hubs is in part a natural outgrowth of the economies of scale associated with hub-and-spoke systems. To take

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advantage of these scale economies, an airline must run a large number of flights in and out of its hub airport. In many cases the scale of operations necessary for one airline to support a hubbing system is also large enough to satisfy most of the demand for "local" travel to and from the hub airport. The result is that many airports receive extensive service from their hub airline but very little service from any other airline. Often, the only service offered by another airline is flights to its own hub airport. For instance, United serves Minneapolis/St. Paul, Northwest's primary hub, but only with flights to Denver and Chicago, United's two largest hubs.

Natural scale economies do not completely account for declining competition at the hub airports, however. Since deregulation, airlines have introduced marketing devices that complement the natural advantages of dominating operations at a particular airport. The best known of these are the frequent flyer programs that give travel bonuses to purchasers after they have flown a certain number of miles on the airline. A similar but less-well-known program is the travel agent commission override through which an agent can earn an increased commission if he books a certain amount of travel on a specific airline. Each of these devices tends to give an advantage to the largest airline at an airport and thus makes it more costly for a new airline to enter and compete.

The airlines' formation of hub-and-spoke networks since deregulation represents both an important advance and a serious anticompetitive influence. Hubs have lowered airlines' costs and increased the number of flights offered on some city-pair routes, but there are discrepancies between prices at dominated airports and elsewhere.

Limits on airport capacity as well as the methods of allocating it among airlines have also tended to increase fares at the hubs. The scarcity of gate facilities at many large airports would drive up prices to some extent even in the most competitive markets, and capacity management at most airports has further damped competitive forces. Long-term leases on gates and the dominant airline's power at many airports to block airport expansion plans have strengthened the hand of an airline with large operations at an airport.

Suggestions that the government investigate the discrepancies between prices at dominated airports and elsewhere have been met with warnings about the dangers of reregulation. More specific opposition has been couched in three arguments. First, some opponents have argued that once appropriate adjustments for the flight distance, the number of stops, and other factors are made, prices are no higher for travel from dominated airports than for other domestic travel. Second, many have stated that even if prices are higher, travelers to and from dominated airports are compensated for the higher prices with better service on these routes, most notably more frequent and more nonstop flights. Finally, a few have argued that even if prices are higher and increased service does not justify the increased prices, the airport dominance problem is just an unfortunate and inevitable outgrowth of the efficient hub-and-spoke systems, which clearly yield greater benefits to travelers as a whole than the costs they impose on some local passengers. Therefore, any government intervention would be unwise.

Does It Cost More to Fly to Dominated Hub Airports?

Measuring and analyzing prices in the airline industry is complicated both because of the multiplicity of products that airlines sell—flights on different routes—and because of the multiplicity of prices that an airline charges for different seats on the same route. To address the problems created by multiple fares on a single route, analysts often determine the average ticket price and compare that with some notion of a competitive price. But determining the competitive price is not straightforward. The cost of providing air travel varies with distance, but the relationship is not strictly proportional—providing an 800-mile trip costs the airline more than providing a 400-mile trip, but it does not cost twice as much. Thus, comparing price per mile for different distance routes is not valid. The simplest and probably least controversial way of adjusting for cost differences is to compare the average prices on different routes of roughly the same distance.

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Table 1: Comparison of Prices at Dominated Hubs to All Other Routes

Airport	Dominant Airline	Dominant Airline Prices (percent of prices elsewhere)	Other Airline Prices
Chicago O'Hare	United	124	117
Dallas/Ft. Worth	American	134	114
Atlanta	Delta	145	97
St. Louis	TWA	113	91
Houston Intercontinental	Continental	123	107
Pittsburgh	USAir	128	110
Minneapolis/St. Paul	Northwest	129	117

Such a comparison is the basis for Table 1. Using data from July to September 1989, Table 1 compares on a distance-matched basis the average fares on routes from dominated hub airports with the average fares on all domestic routes that do not include one of these hub airports. (These are not the only dominated hubs, but they are the largest hubs of each of the seven largest domestic airlines.) For example, the 28 percent fare premium identified in Table 1 for USAir at Pittsburgh is an average, weighted by passenger-miles provided, of the price differences observed when comparing all USAir flights to and from Pittsburgh with nonhub trips covering similar distances. Table 1 reports a similar comparison between fares charged by the "other" airlines serving these hub airports and prices to and from nonhubs. As the table shows, the dominant airline at each of these airports also charges higher fares than the other airlines serving the same airport.

The basic story does not change when we take explicit account of the different quality of service from the hub airports. There are more direct flights available from hubs than from other airports, so simply comparing hub prices to the national average might be biased against the hubs. After all, it makes sense that people who take direct flights pay higher prices than people who have to change planes.

It may be sensible, but it is not true. Nationwide, for trips of a given distance from origin to destination, direct flights cost about 5 percent *less* than change-of-plane trips of the same origin-to-destination distance. It is true that the average fare for change-of-plane service on routes with a substantial proportion of both direct and change-of-plane flights tends to be lower. When there is no direct-service competition, however, fares tend to be much higher than on direct service routes with no significant change-of-plane competition.

All this explains why the story told in Table 2 resembles that in Table 1. Table 2 examines only fares for direct flights. The only noticeable change is in the prices charged by other airlines. They are now closer to those of the dominant airline. This is explained by the fact that most of the direct service offered by other airlines is to the other carriers' own dominated hubs.

The story would not be much different if the table were also subdivided by the number of daily travelers on a route. Thinner routes do have higher prices—due possibly as much to the diminished competition on such routes as to the higher costs of serving them—but adjusting for

Table 2: Comparison of Direct Prices at Dominated Hubs to All Other Direct Prices

Airport	Dominant Airline	Dominant Airline Prices (percent of direct prices elsewhere)	Other Airline Prices
Chicago O'Hare	United	130	126
Dallas/Ft. Worth	American	139	117
Atlanta	Delta	150	95
St. Louis	TWA	118	83
Houston Intercontinental	Continental	126	102
Pittsburgh	USAir	135	132
Minneapolis/St. Paul	Northwest	133	140

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this difference has little effect on the measures of the dominant airline premium.

Of course, careful analysts will adjust for many other factors in determining the existence and size of a dominant airline fare premium. Examples include the costs attributable to scarce airport and runway space, the size of the aircraft used, and the tourist/business mix of the markets. As the number of explanatory factors increases, so does the necessary sophistication of statistical analysis. Economists at the Department of Justice, the Department of Transportation, the General Accounting Office, the Air Transport Association, Boeing Corporation, Yale University, the University of Maryland, the University of Michigan, and the University of California at Davis have all conducted such analysis. Only the study by the Air Transport Association, a trade association made up of most of the large U.S. airlines, found no relationship between airport dominance and prices. Each of the others has found a positive and significant relationship.

Factors to be considered in determining the existence and size of a dominant airline fare premium include the costs attributable to scarce airport and runway space, the size of the aircraft used, and the tourist/business mix of the market. Most studies have found a positive and significant relationship between airport dominance and prices.

Does Better Service at a Hub Airport Justify Higher Prices?

This question really has two parts. First, do hub airports actually offer local residents better service? Second, does it cost more to serve passengers travelling to or from hub airports? The answer to the first question is quite clearly, "yes." Given the number of local passengers flying to or from an airport, the number of flights or available seats is much greater at hub airports than at nonhubs. The completely unsurprising explanation is that the large number of connecting passengers at the airport permits the hubbing airline to increase the number of flights without suffering decreased load factors.

The service advantage at a hub airport is quite pronounced. At major hubs with relatively small local populations, such as St. Louis or Pittsburgh, passengers changing planes outnumber travelers flying to or from the city. San Diego's airport, for example, serves about 20 percent more *local* passengers than does the St. Louis airport, but because San Diego is not a hub, it has less than half as many daily departures as St. Louis. It is clear that travelers to or from hub airports get increased benefits along with the increased prices. It is even quite possible that most travelers would choose the higher price/better service package of a hub airport over the lower price/poorer service alternative available from most nonhub airports. When it comes to air travel, people who live in cities with hub airports probably are better off than people who live in nonhub cities.

But that is the right answer to the wrong question. In competitive markets prices are driven by the costs of production, not by the benefits that consumers receive from the product. Quality improvements should be accompanied by increased prices only when the quality adjustments cause production costs to increase. In fact, the ability of a firm to inflate its prices solely on the basis of the benefits consumers receive is a fairly good indicator of market power and reduced competition.

So, does it cost more to serve a passenger flying to or from a hub airport than to serve other travelers? Certainly not. The whole purpose of establishing hubs is to raise the airline's operating efficiency and thus lower its costs per passenger. Flights to and from a carrier's hub tend to have higher load factors than its other flights. The hub-and-spoke system allows the airline to centralize aircraft maintenance and to utilize personnel at the hub airport more efficiently. Overall, planes flying to and from hubs are used more hours per day and have more passengers on board on each flight.

Are Hub Airports and Higher Prices Inevitable?

To advocate eliminating hub airports would be as economically and politically foolish as to argue for reinstituting price and entry regulation in the industry. (Accomplishing the former would almost certainly require adoption of the latter.) More than forty years of extensive intervention in the airline industry clearly demon-

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strated the inability of the government to participate effectively and efficiently in day-to-day airline management decisions. There is, however, a large, if somewhat fuzzy, area between government management of the industry and a pure laissez faire policy. As in most industries, the optimal level of intervention may be somewhere in between.

The efficiencies an airline attains from operating a hub will give it some competitive advantage at its hub airport. If that were the whole story, we would also expect those efficiencies to be reflected in lower, not higher, prices at the hub. For economies of scale to produce both lower costs and higher prices, there must be some other barrier that reduces the threat of competition even when the incumbent's prices are set above the costs of potential entrants.

Sunk costs associated with entering a market often are the source of such barriers. If a potential entrant faces high enough unrecoverable one-time costs when entering a market, entry will be discouraged even when prices are well above its production costs. This is particularly true when potential entrants recognize that the incumbent is charging a price substantially above its own costs, so that it could respond to entry by reducing its price significantly without suffering negative profits. The key then to diagnosing the causes of inflated prices at hub airports is to determine the kind and magnitudes of sunk costs potential entrants face.

In the case of airlines, sunk costs of entry are directly related to the scale of entry necessary to be competitive. If an airline can compete effectively by serving just one or two routes from an airport with only a few flights per day, then it will incur lower costs of entry than if the viable entrant must start service on many routes simultaneously. The factors that raise the minimum scale necessary for successful competition—and thus raise the sunk costs of entry—can be usefully divided into those that are a direct consequence of the size of the incumbent's operations at the airport, what might be termed the "natural advantages" of the dominant airline, and those that arise from marketing techniques that are not inextricably linked to the operation of a hub, what I term "strategic advantages."

The most obvious natural advantage is the reputation developed by an airline with a large presence in a particular area. A slight variation on a common predereguation theory in the airline industry holds that if customers do not know which airlines serve a particular route, they are likely to call first the airline that serves the most routes or has the most flights from their home airport. For at least two reasons this effect alone probably explains only a very small part of the advantage from airport dominance. First, the proportion of people who book their domestic flights through a travel agent has grown steadily since deregulation and now stands at about 80 percent. Preferences arising from imperfect information should not influence the decisions of travel agents. Second, under regulation all airlines serving a route necessarily charged the same fares so that the benefits to shopping around were much smaller than they are now. In the 1960s a customer calling several airlines might have located a more preferred departure time, but she would not have found a lower price.

To advocate eliminating hub airports would be as economically and politically foolish as to argue for reinstituting price and entry regulation in the industry. Extensive intervention in the airline business for forty years has clearly shown the government's inability to participate effectively and efficiently in daily airline management decisions.

Other information-based hypotheses are also suggested to explain an airport dominance effect. Advertising is likely to have a greater impact per dollar for an airline that serves many routes from a city than for one that serves only a few routes. Consequently, the dominant airline is likely to do more local advertising than will carriers with smaller operations in a city. Similarly, because acquiring information about quality of service is costly, the consumer may prefer an airline on which he has already flown. This is likely to be the airline with more flights from his originating airport.

Frequent-Flier Programs. Although the nature of the airline industry would seem to imply that these information advantages will flow to the major carrier in a city, airlines have in recent years created new marketing devices that aug-

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I SUPPOSE THIS NEW SYSTEM IS TO LET US KNOW HOW LONG WE'LL BE DELAYED.
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ment these advantages. Frequent-flier programs, for example, were developed to induce brand loyalty, and they are particularly beneficial to a dominant carrier in an area. If an airline serves more routes and has more flights from a city, then both the majority of a local resident's future flights are more likely to be on that airline than on any other and that airline is likely to serve a wider variety of "payoff" destinations from the city-destinations that are particularly attractive prizes when awarded as frequent-flier bonuses.

The importance of the first effect results from the fact that the prize value per cashed-in mile increases with mileage. This reward structure encourages customers to minimize the number of different airlines on which they accumulate their frequent-flier mileage. The second effect might be seen as an artificial network economy. By making the frequent-flier bonus a future trip on "any route we serve in the United States," the carrier creates an option on future travel that increases in value with the number and variety of points served by the airline from the frequent-flier program member's home airport. Both of these effects are magnified when the traveler who receives the bonus does not bear the full money or time costs of adjusting travel plans to take advantage of the program, such as when the traveler's time and ticket price are paid for by his employer.

New marketing devices contribute to a dominant airline's competitive advantage. These include frequent-flier programs, travel agent commission override programs, and computer reservation systems. These are strategic advantages, not inextricably linked to the operation of a hub.

It is possible that smaller carriers at an airport could challenge the dominant airline's advantage by forming affiliated frequent-flier programs in which the mileage earned on many different carriers could be combined to receive a free trip on any one of those airlines. Unfortunately, the costs of establishing such agreements and then enforcing them seem to be quite high. Furthermore, even a combination of the second, third, and fourth largest airlines at many hub airports would still leave the size of their operations at that airport—and thus the attractiveness of their combined frequent-flier programs—far behind that of the dominant airline. And, of course, airlines that might consider a combined program to overcome the dominant carrier's advantage at one airport would be interested in exercising a similar advantage at the airports they dominate.

Some observers have also suggested that a new entrant could overcome the dominant incumbent's advantage by offering to accept the mileage that customers have built up on the incumbent's program, just as some airlines (and many pizza parlors) respond to coupon offers of competitors by accepting the other firm's coupons. But the financial liability created by such an offer would further increase the sunk start-up costs for the entrant and thus would bring us back to the original problem. Furthermore, the average traveler will still expect that most of her future flights will be on routes that the dominant firm serves, so that she remains better off in terms of the frequent-flier program to concentrate all of her business with the dominant firm.

Travel Agent Commission Override Programs. The commission system that is the basis for travel agent remuneration exhibits many of the same properties and problems of frequent-flier programs. Travel agent commission override programs are contracts between an airline and a travel agent in which the airline agrees to increase the agent's commission rate, from 10 percent usually to somewhere between 12 percent and 18 percent, if the agent reaches certain sales goals. The goals may be stated in terms of a certain dollar volume of sales—for example, the commission rate would be increased if the agent

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sells more than $80,000 of travel on the airline in a month—or in terms of a certain share of the agent's business—for example, the commission rate would be increased if more than 60 percent of the agent's air travel sales are with that airline. Commission override programs are essentially frequent-booker programs that, as with frequent-flier programs, can be used most effectively by the dominant carrier at an airport to bias brand choice in travel purchases.

In a 1988 survey of travel agents, 24 percent of the 702 responding said that their choice of carrier was "usually" affected by override payments, 27 percent said "sometimes," 13 percent said "rarely," and 35 percent said "never." Given the complexity of airline pricing and seat availability these days, it is simply unrealistic to think that competition will discipline any agent who pursues commission override programs rather than the client's best interests. The average customer would find it very difficult to monitor his agent closely enough to detect with confidence every breach of the agent's responsibility to the client.

Computer Reservation Systems. The most publicized strategic tool in the airline industry is probably the computer reservation system. In the past, airlines that owned computer reservation systems listed their own flights first, ahead of competing flights from other airlines. This practice was banned by the Civil Aeronautics Board in 1983 because it was argued that it biased the airline choices of travel agents and, thus, of consumers. If some subtle biases remain, they are likely to benefit the dominant airline in an area because, when other things are equal, travel agents are more likely to use the computer reservation system owned by the locally dominant airline.

One advantage of owning a computer reservation system may be its use in implementing travel agent commission override programs that link the commission override to the share of airline bookings that an agent makes on a certain airline. Such schemes require data on all of the agent's bookings—data that will be immediately available to the airline that owns the computer reservation system used by the agent for ticketing.

The Impact on Market Share. Name recognition among local customers, advertising economies, frequent-flier programs, travel agent commission override programs, and computer reservation systems all probably contribute to a dominant airline's competitive advantage. One way to see the magnitude of this advantage is to examine how airport dominance increases an airline's share of the passengers who regularly use the airport. The factors discussed will affect people who live near and originate their trips at the dominated airport with a dominant carrier much more than people who live elsewhere and are traveling to that airport. Travelers are unlikely to be affected very much by the advertising of the carriers that dominate their destination points. Similarly, the frequent-flier program of the dominant carrier at the destination point will have no particular appeal to these customers, nor will the commission override program of that airline have much influence on the travel agent in a distant originating city.

One way to assess the magnitude of a dominant airline's competitive advantage is to examine how airport dominance increases an airline's share of the passengers who regularly use the airport. An imbalance in market share based on passengers' originating points would be hard to attribute to differences in price or quality of service.

To give a concrete example, there would be a strong indication of a competitive advantage for the airports' dominant airlines if Delta served most of the Atlanta-Minneapolis local passengers who originated their trips in Atlanta while Northwest captured most of the passengers whose trips began in Minneapolis. This is in fact the case. Delta gets 66 percent of the round trip nonstop passengers on this route who start their trips in Atlanta compared with 28 percent of Minneapolis-originating passengers. Northwest gets 72 percent of the nonstop round-trips that originate in Minneapolis and only 34 percent of those originating in Atlanta.

Such an imbalance in market share is hard to attribute to quality or price differences. An airline charges the same price on a route regardless of the point from which the passenger begins his trip. The quality of service is also independent of the passenger's point of origin, since regardless

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of the endpoint from which the passenger starts, she takes one flight in each direction on the route; only the order of the two flights depends on the origination point.

Using this sort of comparison and controlling for the few factors that differ by the passenger's point of origin—most important, the convenience of flight scheduling for trips in each direction—I have estimated that a .25 percent increase in an airline's traffic share on a particular route will result from a 1 percent increase in airport dominance, that is, a 1 percent increase in the airline's share of all other traffic originating at the airport. Similarly, if airline *A* is competing against airline *B*, a 1 percent increase in *B*'s airport dominance will lower *A*'s share on the route on which they compete by .25 percent.

The market share advantage generated by airport dominance is twice as large on business routes as on routes that serve primarily tourists. This is consistent with the fact that airport dominance tends to increase the fares paid by the high-end customers more than it increases the prices of discount tickets.

Thus, if one airline with a 60 percent share of all trip originations at an airport (this number is typical of the dominant airline's origination shares in Table 1) were competing on a specific route against another airline that had a 10 percent share of all airport trip originations, the 50 percent airport share differential would imply a 12.5 percent market share advantage for the dominant airline on the route over which the two airlines compete. That sort of gap can easily be the difference between profitable and unprofitable operations on a route.

It is noteworthy that the market share advantage generated by airport dominance is twice as large on business routes as on routes that serve primarily tourists. This is consistent with the fact that airport dominance tends to increase the fares paid by the high-end customers more than it increases the prices of discount tickets. Both facts indicate that frequent-flier programs, which are targeted primarily at business travelers, are probably part of the cause of the advantage arising from airport dominance.

Not only do the natural and strategic marketing advantages of the dominant airline make it difficult for another airline to attract passengers, but the allocation and production of airport terminal capacity present barriers that also deter new entry. At many airports, gates are leased on a long-term basis—usually at below-market prices. This practice often allows a single airline to control most of the gate capacity available at the airport. With the low lease fees and long-term control, a dominant airline can find it profitable to buy up a disproportionate share of airport capacity to restrict the supply available to potential competitors.

Equally important in reducing access to airport space is the control that incumbent airlines are often given over the supply of new gates and other airport facilities. The long-term lease agreements often protect the investment of incumbent airlines by giving them a voice in the decision to build additional gates. In addition, the most common method of financing airport construction and expansion asks incumbent airlines to purchase or guarantee bonds issued by the local airport authority. In return, the incumbent is inclined to demand restrictions on facility use. At a few airports, incumbent airlines have agreed to finance construction of new facilities only after receiving assurances that older facilities will be decommissioned so that no net increase in gates will result.

Policies for Increasing Competition at Hub Airports

We certainly would not want to live without hubs, but different government policies might make it easier to live with them. Rather than replacing competition with government-imposed price ceilings, changes in policy should be aimed at increasing the competitive pressures felt by airlines at their hubs. It is unrealistic to expect an entrant to immediately establish a second hub at an airport, but the barriers to entry facing nondominant competitors could be reduced. Some proposals to consider follow.

First, eliminate frequent-flier programs, perhaps with some time lag such as two years. (This need not relieve the airlines of their current liabilities for mileage earned.) Not only do frequent-flier programs give a competitive advantage to a dominant airline, but they are a kick-

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back that results in inefficient decisions if the person receiving the bonus is not the one paying for the ticket. Furthermore, because they are untaxed compensation to employees, frequent-flier programs work in part as a tax scam that reduces Treasury receipts.

Second, require travel agents to post the average commission rate they received from each airline over the previous three-month or six-month period. This may not be effective if customers are unwilling to use the information, but it is a low-burden way to put buyers on notice that the agent is looking out for his own interests as well as those of the customer. When I see that my agent gets a much higher commission from United than from Southwest, I am more likely to be suspicious if he neglects to mention any Southwest flights.

Third, do not allow incumbents to deter entry at an airport by locking up gates with long-term leases or by vetoing expansion plans. Local airport authorities should shorten the terms of leases on airport facilities and should give priority to other firms if a dominant incumbent is underutilizing the facilities it holds. Alternative financing sources for airport expansion should be found to lessen the influence of incumbent airlines on these decisions. Some federal government participation might be appropriate since airports, particularly hubs where people are changing planes, are used by many people who do not live in, or even travel to, the immediate area of the airport.

Fourth, enforce the antitrust laws against mergers between airlines with systems that overlap substantially. The Department of Justice now has authority for antitrust enforcement in the airline industry. Unlike the Department of Transportation, which had this authority until 1988, the Justice Department seems to understand that entry in airline markets is not so easy that antitrust policy should be based on theories of the shadowy "potential competitor."

Probably the worst outcome from the current debate on airline policy would be to return to the old price and entry controls that failed us for decades before deregulation. Recognizing that, however, should not inhibit implementation of prudent public policy. In fact, policies that promote competition in the industry may be the most effective defense against those who advocate replacing competition with government control.

Without some action, the decline of competition that has been evident since the mid-1980s will continue. Entry of new firms into the industry has virtually ceased, and expansion of low-cost airlines into the strongholds of older, higher-cost carriers has been greatly curtailed.

Different government policies might make it easier to live with hubs. Rather than replacing competition with government-imposed price ceilings, changes in policies should be aimed at increasing the competitive pressure felt by airlines at their hubs. Barriers to entry facing nondominant competitors could be reduced.

One lesson we learned from the legacy of massive government regulation is that it interferes with the efficient operation of an industry. The lesson we should now learn from the era of deregulation is that a laissez faire policy can also lead to failures of competition and to the loss of economic efficiency.

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Readings

Competition + Commitment = Success

The Competitive Advantage of Nations
by Michael E. Porter
(The Free Press, 1990), 855 pp.

Reviewed by Paul A. Pautler

In *The Competitive Advantage of Nations* Michael Porter tries to give us a theory of industrial advance and decline that captures all the complexities of competition. What he delivers is an interesting, if somewhat long, story of industrial change drawn from case studies from around the world. Porter believes that competition occurs not among nations but among firms and that the best way to attain high per capita productivity and income is to win the battle at the firm and industry level. The battle is won when firms and industries are able to improve continuously in four areas that compose Porter's "diamond": inputs such as worker training and motivation and a technology base; demand conditions (for example, buyers that demand high-quality and cutting-edge products); synergies with (or prodding from) related industries; and firm strategy (for example, commitment to the industry) and rivalry. The four elements work in conjunction with and reinforce each other to produce and maintain competitive advantage. For example, an industry will obtain international advantage if several rival producers can draw upon well-trained labor and state-of-the-art supplier industries to satisfy demanding domestic consumers who push the industry to high quality standards. Continuously upgrading these various elements yields sustained advantage because the process naturally results in barriers to entry by rival industries and nations. The effects of government and chance events are important, but clearly subsidiary, parts of Porter's story.

After 175 pages of theory liberally sprinkled with examples from various nations and industries, the reader reaches a fascinating discussion of several successful industries including printing presses in Germany, patient monitors in the United States, ceramic tiles in Italy, and robotics in Japan. The industry studies are followed by a lengthy description of the development of firms and industries in ten nations. These national descriptions not only include some interesting stories, but also reveal Porter's thinking on several important issues. For example, Porter likes technically trained corporate executives and has little use for finance-types. (This is interesting coming from a B-school professor.) Porter also dislikes capital market "churning." While he praises capital markets that provide funding for innovative firms or allow low-cost access to funds (as the U.S. capital markets did in the 1950s and 1960s), Porter is not very kind to those who would actively trade stocks based on short-term perspectives. He is a firm believer in "buy and hold" strategies and in industry *commitment*. In fact, the commitment theme repeats itself throughout the studies of industries and nations. According to Porter, commitment is the key in several Italian industries where owners and workers would rather die than quit. U.S. commitment, by the way, falls far short of the commitment of Japanese and Korean firms.

After Porter has guided the reader through the countries, he moves on to the theory of national competitive advantage. This draws on his theory of firm-level advantages, and he attempts to answer several questions. Do countries matter? If so, how? And what can a country do to enhance its advantages? Porter identifies four stages of national industrial development: the factor-driven stage (Singapore), the investment-driven

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stage (Korea), the innovation-driven stage (Japan), and lastly the wealth-driven stage (of the nations studied, only the U.K. has fully reached this last stagnant stage). The correct policy for industry and government depends on the nation's developmental stage, with more direct subsidies and central planning activity being tolerated at the earlier stages. For more advanced nations, Porter recommends that, among other things, governments can subsidize the development of highly trained labor, signal (but not "target") important areas for research via their behavior as sophisticated buyers, challenge industry through buyer behavior and forward-looking regulations and standards, discard antiquated regulations, and foster competition.

Readers who are not initially convinced by Porter's story, will not be swayed by the evidence he presents. Part of the problem is that he makes no effort to put the apparently extensive case-study data in a systematic form that would allow statistical analysis. While such an analysis might suffer from the garbage-in-garbage-out phenomenon, there might also be some chance of determining whether any patterns emerge from the case studies. It is also unclear whether the four elements of Porter's theory explain nothing or everything. The theory is so all-emcompassing and the feedback among elements of the theory so diverse that it is hard to pin down the conditions he thinks are necessary or sufficient for an industry or nation to succeed internationally. Virtually any observation could be fit into some niche of his theory.

Although Porter fails to cite much of his evidence, several of the arguments in the book are consistent with research using the Federal Trade Commission's line-of-business data summarized by David Ravenscraft and Curtis Wagner in a paper prepared for a June 1990 Chicago Law School conference. For example, Porter argues that diversification is generally a bad idea, particularly if it is done outside the firms' general core area of expertise by "buying into" an industry rather than through internal expansion. This is consistent with much of the line-of-business research that tends to find that "core skills" matter—firms do better when they diversify into technically related areas rather than into unrelated fields. Thus, the conglomerate merger movement of the 1960s and 1970s was probably a mistake.

Despite the complexity of Porter's four-pronged diamond theory, one factor seems to play a key role in the development and continuation of winning firms and industries. That key element is *rivalry*. Porter argues that the United States was set apart from the rest of the world in the 1950s and 1960s by a "can-do" attitude and a policy of competition. Porter's reading of the case evidence leads him to conclude that competition provides the correct incentives for innovation and advancement. On the basis of this idea, Porter reaches relatively strong policy conclusions. He would allow trade association information exchanges and would foster information exchanges along the chain of suppliers, manufacturers, distributors, and retailers. He would, however, carefully circumscribe cooperative R&D, block all mergers of leading firms, and generally "deconcentrate economic power."

Porter's emphasis on rivalry and competition would make most readers expect an effort to define those terms. But Porter provides no such definition. Indeed, it is difficult to tell whether one domestic competitor is enough (if sufficient foreign rivals exist), whether three major domestic rivals are enough (Coke, Pepsi, and 7Up in softdrinks or AT&T, MCI, and Sprint in telecommunications), whether four or five rivals are required (as is the case in Korea), or whether hundreds of competitors are necessary (as in Italian tile and a few Japanese industries). Maybe competition and rivalry have little to do with the specific number of domestic firms, but it is hard to tell from Porter's discussion or his policy prescriptions. A further conundrum is created because he seems to define markets quite broadly. For example, at one point Porter discusses a broad array of competing technologies for fire protection services including fire detection, sprinkler systems, and security guards. If one used similarly broad definitions for other products, very few markets could be said to be "comfortable oligopolies," as he describes many current U.S. industries.

Porter's affinity for a large number of rivals leads him to chide the Reagan administration in the United States but applaud the Thatcher government in Britain. Given that these two administrations were often viewed as soul-mates, the evaluation seems a bit strained. The contrasting opinions may occur because Porter sees Thatcher's policies as appropriate to move Britain out of its lackluster wealth-driven stage, but similar philosophies are inappropriate for the United States, which remains in an innovation-driven stage. Specifically, Porter criticizes what he

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views as Reagan's lackadaisical antitrust policy, while praising Thatcher's policy of privatization designed to enhance competition in previously monopolized sectors.

Unfortunately, Porter's characterization of U.S. competition policy is unconvincing. The Reagan administration seldom allowed mergers to the point where only a very few firms remained in an industry (except possibly in instances where several significant international competitors existed). So the U.S. market cannot be said to suffer from a lack of competition, unless Porter believes that five or six domestic competitors are required to reach the necessary level of rivalry. (Again, the book is quite fuzzy about the specifics of adequate competition.) In addition, Porter dates the U.S. decline in product and process innovation from the early to mid-1970s, well before the Reagan era.

Despite the lack of systematic evidence, Porter offers three intriguing (if unproven) propositions. First, imposing certain cost-increasing regulations (health, safety, and environmental regulations) on firms early is good, because it forces the regulated firms to improve early and thus gives them important technical advantages when the slacker nations catch up and regulate later. Second, selected weaknesses are really strengths. A lack of some important (but apparently nonessential) element often challenges firms and industries to perform better than firms and industries that do not have to overcome such a hurdle. This minimalist idea reappears throughout the book. Porter goes so far as to argue that the United States lost its international lead in large part because it had too few "selected disadvantages." Finally, property rights do not matter very much for innovation. Competition drives innovation, and rights to exploit one's innovation via a patent are relatively unimportant. Each of these three propositions, if supportable, deserves its own book.

Porter's book is more than an expensive paper weight, although it would serve well in that capacity. Porter challenges the reader to think about "industrial policy" in a different way. Unfortunately, he requires his readers to take a lot of his evidence on faith. If Porter is right, however, the nations that will win the fight for competitive advantage and better living standards for their citizens are those that keep lean and hungry industries committed to searching for the most recent technological or marketing innovation with which to ravage their many rivals. I doubt that Porter would care to predict which nation will come up with any particular innovation, but he is sure it will not come from firms or industries that are not pushed to it by the threat of losing out to aggressive competitors.

Injudicious Distortions

Judicial Compulsions: How Public Law Distorts Public Policy
by Jeremy Rabkin
(Basic Books, 1989), 322 pp.

Reviewed by Steve Lenzner

Appeals to the public interest, which in sounder times went by the grander name of "justice and the general good" (*Federalist* #51), are likely to be dismissed today by most people with a disdainful shrug, a wry smile, or a knowing wink. Everyone knows that politics in America is about getting for oneself and his friends what he can, whenever he can. What everyone does not know, and what Jeremy Rabkin describes clearly and forcefully in his new book *Judicial Compulsions: How Public Law Distorts Public Policy*, is how completely this rather vulgar conception of politics is entrenched in judicial activity, particularly, though by no means exclusively, in the field of administrative law.

Rabkin, a Cornell government professor, has two purposes in writing this book. His immediate and practical aim is to demonstrate how contemporary administrative law, by ignoring the logic of our constitutional order, has degenerated into a system in which judges set themselves up as "unaccountable, episodic managers of regulatory performance." Over the past 20 years or so judges have increasingly parceled out to contending interest groups peremptory claims on public policy. Rabkin demonstrates this in his section "Distortions of Practice" by offering detailed case studies of how unwarranted judicial interference has hampered, and in some cases crippled, executive policymaking at the Office for Civil Rights, the Food and Drug Administration, and the Occupational Safety

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and Health Administration. (It is to Rabkin's credit that he can make even OSHA interesting.)

In these chapters Rabkin shows how judges have consistently (and masterfully, in a perverse sort of way) avoided deciding whether a specific individual's rights have been violated and whether he is entitled to a specific legal remedy. That is to say, Rabkin demonstrates how judges have avoided the stuff of judging. What we see instead are judges who irresponsibly blur the distinction between individual rights and the claims of special interest groups.

In practice, this judicial obfuscation leads to a predictable pattern of judicial compulsions. An agency faced with limited resources and great demands is forced to establish regulatory priorities. As it does so, one interest group or another objects in court that its right to regulatory protection has been denied. The judge, accepting the interest group's claim, forces the agency to redirect its resources towards the asserted "right," no matter how trivial it may seem in comparison with the agency's other responsibilities. Inevitably, "as policy decisions become mired in legalism," less vociferous though often publicly more important interests are slighted or ignored.

Consider the example of the Occupational Safety and Health Administration. Rabkin describes a series of misguided cases that effectively rendered almost unimplementable OSHA's rather broad regulatory task—seeing that every worker has a safe working place "to the extent feasible." By refusing to limit who could sue, the courts opened the door to mischief, and OSHA justifiably became "entitled to assume that it would be dragged into court any time it promulgated a new standard that did not satisfy an advocacy group demanding tighter standards." In turn, this development further encouraged OSHA—which had never been an agency overly influenced by economic realities—to ignore whatever costs its standards might impose on a regulated industry. After all, as OSHA told itself (and the rest of us), lives were at stake. Finally, after one egregious standard followed another (including at least one that was estimated to impose costs of over a billion dollars per life saved), the court put its foot down—at least temporarily. In 1980 the Supreme Court determined that whenever OSHA imposed a particularly rigorous exposure standard involving substantial compliance costs rather than a less stringent standard—as in the case of the benzene standard—then OSHA had to show that the additional costs were " 'at least more likely than not' . . . to secure some 'significant' additional health benefit." The very next year, however, the Supreme Court espoused a new doctrine forbidding OSHA from considering costs when lives were at stake unless the costs of compliance threatened the economic viability of the industry.

Rabkin explains: "The results . . . left OSHA exposed to serious challenges from both sides. If its standards imposed heavy costs on particular industries, they were virtually certain to be challenged by industry, which would demand 'substantial evidence' that the stringency of a particular standard was justified by 'significant' health benefits." Given the "paucity and ambiguity of most scientific evidence regarding particular . . . exposure levels," OSHA found it rather difficult to defend particularly strict standards. But if the agency took the opposite tack and tried to balance the costs of compliance against additional safety, unions and advocacy groups were likely to challenge proposed standards. In fact, on occasion OSHA faced lawsuits over the same standard from both business and labor.

Predictably, these conflicting pressures led to administrative paralysis. OSHA felt its credibility was questioned whenever the courts overturned proposed standards, and the agency was "particularly reluctant to commit enforcement resources and staff if it could not be sure the standard would survive judicial scrutiny." In 1978, the year the lower court initially ruled against OSHA's benezene standard, the agency promulgated six new health standards; in the five years following it produced none. From 1979 to 1988 the agency promulgated only four standards. This is not to say that OSHA was completely inactive during those years; it did on occasion propose standards that were never implemented. For example, in 1985 OSHA proposed a new standard for formaldehyde at an estimated cost of $72 billion per life saved. The regulation did not go into effect.

Rabkin's second, larger aim is to remind us of the "grounding assumptions" of American constitutionalism that have been unceremoniously uprooted by the new administrative law. In his section "Confusions of Thought" he attempts to revive the traditional understanding of two ideas central to our constitutional scheme: rights and responsibility. Traditionally a right

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was understood to be a specific claim an individual could raise on his own behalf against others—both private individuals and members of the government—which, if valid, a court was obligated to uphold. Under the new administrative law, rights belong not only to individuals but also to groups. Rabkin argues that this shift in meaning is as theoretically unjustifiable as it is practically harmful.

Rabkin views a right as properly individual because it is essentially private. To say that one has a right to something means that that right is his to exercise or assert. Conversely, it also means that he may choose not to exercise or assert it. But in the case of, say, the public's "right to clean air," who can properly speak for or decline to speak for the public? Who is able to responsibly balance the public's desire for clean air with the high costs associated with that end? To say, as courts are wont to do, that one or another environmentalist advocacy group speaks for the public is merely to assign to that group the privilege of speaking "for unknown or indeterminate others to whom it has no meaningful accountability." As Rabkin notes, it is precisely for this reason that American law has traditionally been very uncomfortable with group rights, for there is something most disturbing about rights "over which the right holder has no control."

In practice, this habit of assigning public rights to private groups has the effect of reducing "public policy . . . to the legally protected claims of contending interest groups." The executive branch, whose role has traditionally been to implement the law energetically, is reduced to a minion of the judiciary. The executive branch is no longer supposed to deliberate prudently about the best way to implement the laws by stressing some and deemphasizing others depending on the circumstances. Rather, under the new administrative law, the executive is supposed merely to follow orders. He is required to carry out the law as the judges see it. By "opening the courthouse doors to claimants seeking more or better regulation, contemporary administrative law makes the judge responsible for the implementation of public measures." And this, according to Rabkin, is the crux of the problem. Though they are in large measure to blame for many of our current problems in public policy, judges are not and cannot be in the strict sense responsible because they answer to no one (except perhaps other judges).

"PITY I DIDN'T HAVE A U.S. SUPREME COURT..."

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It is important to remind ourselves at this point that the very concept of governmental responsibility is an American invention (the word's first known published use is in *Federalist* #23). Although Publius rarely speaks of judicial responsibility, it is "the central theme in the *Federalist*'s discussion of executive power," as Rabkin notes. The executive branch is politically responsible because it is theoretically unified and publicly accountable. Because all executive decisions, in theory, stem from the president, and because the president will most surely be blamed for inept or foolish administration, Rabkin contends that "the executive must give continual thought to the public interest in deciding how to exercise the powers bestowed by legislation. This responsibility requires the executive to make disputable political judgments, but that is why the executive is made responsible to the people—unlike the judiciary, which can simply claim to be following previously fixed rules with no regard for consequences." Rabkin concludes that "the separation of powers is designed to make one part of government squarely responsible for the actual consequences that flow from the legislative 'intentions' of all of the nation's diverse laws." When judges force executive officials to answer to the regulatory demands of private citizens in the name of the law, this idea of responsibility—"the essential purpose behind the scheme of separated power"—is displaced if not destroyed.

Rabkin's book not only reeducates us about specific principles most of us have apparently forgotten, but, more important, teaches us how we ought to think about courts and constitutionalism in general. Building on Harvey C. Mansfield, Jr.'s work on the forms and formalities of liberty (related in his excellent new book, *Tam-*

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ing the Prince), Rabkin persuasively argues that in the American constitutional scheme the form of the judiciary—its insularity and unaccountability—should dictate its function. Or more accurately, Rabkin argues that judges are insulated and unaccountable in our system precisely because we want them to look at rights without regard to larger social consequences: "The point of separating judges from the rest of the political system is precisely to preserve the private or detached character of individual rights." This form is obviously perverted when private rights are fused with the policy demands of interest groups, for regardless of its policy consequences, such fusion encourages forgetfulness about what it means to live in a constitutional regime. As Rabkin demonstrates, forgetfulness is the first step towards decay.

By powerfully reminding us of the principles of constitutional government, Rabkin has rendered us all a service. At the very least, he has written the best book on compulsions since Freud.

Promise of Free Market Environmentalism

Economics and the Environment: A Reconciliation
edited by Walter Block
(The Fraser Institute, 1990), 332 pp.

Reviewed by William C. Dennis

Everyone seems to have discovered "the environment" these days, and commentators from all over are predicting that the politics of the 1990s in the Western democracies will be decidedly green. Many of those interested in environmental questions have other political agenda that they hope environmental advocacy will further—population control, economic redistribution, an end to consumer-driven economic growth, and the development of a more communitarian morality, to name just a few. As the first essay in this book, "The Economics of the Conserver Society," makes clear, all these arguments have been around for a long time and are largely recycled efforts from previous causes. What makes them so politically potent today is that they have been tied to issues of interest to the affluent middle-class West—urban green spaces, park land, wildlife preservation, public health—and to potential public-good problems of global significance. The usual list includes most prominently the greenhouse effect, ozone depletion, acid rain, and species extinction.

It is especially troubling that a market-oriented, minimal government, proliberty approach to all these questions has played so small a part in the public debate. In the United States, at least, every politician wants to be on the side of the environment, and the little political opposition to environmental policy initiatives still seems to be mired, for the most part, in beside-the-point arguments about expense and jobs lost, rather than founded on a defense of the environment of liberty. Despite more than a decade of solid research on environmental questions from a free market or new resource economics perspective, much of which is reflected in the essays in this book, little of this turns up in the popular press, on national television, or in the policy debates in Washington. There have been a few modest successes such as the Coastal Barriers Resource Act, higher user fees for public amenity resources, limited programs of emissions trading, the defeat of the Law of the Sea Treaty, and, until recently, no massive programs to deal with alleged problems stemming from acid rain and increaases in greenhouse gases.

Will this book and others similar to it redress the balance? Will these authors begin to appear on "Nightline"? Will they be quoted in *Time*? Will friendly congressmen ask them to testify at committee hearings? Will the organized environmental groups with their huge budgets (a recent estimate placed the combined budgets of the U.S. nongovernmental environmental organizations at over $400 million annually) begin to include these fine scholars in their conferences and publications? Probably not. Or at least not soon.

Why is this so? The essays of this collection for the most part are careful and moderate discussions of the broad range of current environmental issues—neither overly technical nor (with the exception of the first essay) too general for serious but not expert readers. These arguments deserve wide consideration.

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Chapters 2, 3, 4, and portions of Chapter 10 deal primarily with areas where market-oriented analysis is strongest and most compelling because it can be closely tied to the strength of property rights theory. These chapters demonstrate the transgenerational equity of the market (Thomas E. Borcherding), review the theoretical basis for the new resource economics as the foundation of a political economy of hope (John Baden and Richard Stroup), and develop theory and case studies of the private provision of environmental amenities and wildlife preservation (Terry L. Anderson). All of this is good material, but some of it is at least five years old, and much of it has now been published elsewhere in different forms. A timely presentation of arguments is essential if those in the public policy world are to be asked to take them seriously.

For this reader, the most interesting chapters were those discussing problems of air pollution, both because he was less familiar with the literature and because he has been less convinced by the market-oriented answers. Current technology does not permit air boundaries to be established inexpensively. But such boundaries are, of course, crucial to the development of property rights and, through property rights, laws against air pollution trespass. Policy in this area is complicated further by the fact that a world of zero atmospheric emissions is neither possible nor necessary. The atmosphere is a vast sink into which immense quantities of material can be poured with minimal adverse affects. But at some level, problems do develop. To determine these critical levels, to divide up the rights to produce emissions, and to establish responsibility for reducing existing levels of emissions, particularly in response to possible global environmental problems, would appear to require, even under market-oriented emissions trading rules, vast regulatory schemes and command-and-control-oriented bureaucracies with all the opportunities for rent-seeking that public choice analysis (and recent experience with clean air legislation) would predict—all to the detriment of liberty. Edwin G. Dolan discusses many of these problems in "Controlling Acid Rain," and Jane S. Shaw and Richard L. Stroup are lucid and current in their discussion of "Global Warming and Ozone Depletion." Is there then no good way out of this dilemma?

In this regard "Law, Property Rights, and Air Pollution" by Murray N. Rothbard was the most interesting of the book. Rothbard applies the libertarian homesteading principle to establish property rights to the atmosphere as a sink, and then defends these rights against trespass with a strict liability approach to torts that uses common law procedures where a real plaintiff must prove "a visible and tangible, or 'sensible,' invasion" of his rights against an actual defendant. There is much more to this truly radical essay, which covers such questions as radiation, airspace, class actions, and sophisticated detection of trace pollutants. An article like this should produce long, hard thought, and it suggests as many difficulties with a market approach to air quality as it does solutions. Such an approach is so far removed from the current statist theories of environmental protection, however, that it will probably be ignored by establishment thinkers and many new resource economics theorists as well.

But the great merit of the Rothbard piece, as well as of most of the other essays, is that it is thought-provoking and thoroughly grounded on the ideal of liberty. Those of us who care about both liberty and a high-quality environment should not let any opportunity pass without stating that the environment most favorable to the flourishing of human beings is the environment of liberty. Historically, this environment has been in short supply, and it is easily degraded. Public environmental policies should always be calculated to enhance, not to erode, the institutions of liberty.

Recent Soviet developments have shown that vast state projects cannot produce the promised goods. These lessons need to be applied to public environmental policy, where we also need some *perestroika*. Otherwise government failure will just replace market failure to everyone's disadvantage. A proliberty approach to the environment would be assertive where we know the most, especially in showing how secure property rights in land can provide enhanced environmental quality, and would remain humble and open to learning in the difficult areas of air emissions and long-range global environmental threats. We should insist that environmental policy not be allowed to carry on its shoulders other political agenda that are detrimental to liberty. Thus, for example, if a carbon tax of some sort becomes an attractive policy option, it should substitute for other taxes and not become simply a means for increased government revenue. We should help environmentalists come to understand the idea of economic tradeoffs—that

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in a world of scarcity not all good things are possible at once. We should help them choose depoliticized, less expensive, administratively simpler, and where possible market-oriented policy options. Finally, environmental scare tactics should be decried. By historical standards, we in the West live in a relatively good physical environment and a better-than-average environment for liberty. We do not face a crisis on either front, and we have the time to work out improvements in both areas without slighting either.

As some work to make the new resource economics material more a part of the public debate, others need to expand and intensify the careful and thoughtful study of environment and liberty for which a decade of research provides the basis. But the new resource economics theorists are a long way from becoming major players in the public debate. Ten years of maturing should now begin to produce regular free market environmental features in the leading popular press, frequent television interviews, extensive study of the new resource economics in the college classroom, and publication of new resource economics writings by major presses. Good work is in progress, but there is still a lot to be learned about marketing these works and their ideas if they are to make much of a difference.

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